S. HRG. 99-120, PT. II

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

THE NEED FOR COMPREHENSIVE LEGISLATION WHICH WILL PROVIDE NATIONAL POLICY DIRECTION TO THE FEDERAL REGULATORS AND FINANCIAL INSTITUTIONS TO ADDRESS THE COMPETITIVE ISSUES, THE CONSUMER PROTECTION ISSUES, AND REGULATORY ISSUES BEING RAISED BY THE ONGOING RAPID CHANGES IN THE FINANCIAL SERVICES INDUSTRY

PART II

JUNE 11, 13, 18, 19, AND 20, 1985

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COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

PART II

TUESDAY, JUNE 11, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 10 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This hearing is a continuation of the series begun in early May as an exercise of this committee's oversight jurisdiction.

I welcome the witnesses whom I will introduce shortly and thank them for taking the time to be here today.

The purpose of these hearings is to solicit views from interested and knowledgeable people and groups about changes that have been occurring in the delivery of financial services. These changes appear now to be occurring at an ever rapid and accelerating pace. I'm sure that by now everyone is aware that the Supreme Court ruled that the State regional arrangements are constitutional and it should be noted that S. 2851 came to that conclusion last September, although the House of Representatives did not.

I certainly have said all along tnat a comprehensive bill is necessary and that geographical flexibility is only one of the issues that are on the table.

In this series of hearings we have heard from representatives from the regulatory agencies, from consultants, and from representatives of some of the most diversified companies offering financial services.

Today, we are going to hear from those interested in the impact of this developmental process on consumers.

The revolutionary changes affecting the financial services industry have to a great extent been driven by the increasing sophistication and needs of the retail customer base within the industry.

First, we will hear from Mr. Robert B. Evans, president of the American Financial Services Association, followed by John T. Sutton, second vice president of the National Association of Con-

sumer Credit Administrators. Then we will hear from a panel representing the interests of consumers themselves which will consist of Stephen Brobeck, executive director of the Consumer Federation of America, and Mr. Henry B. Schechter, director of the office of housing and monetary policy of the AFL-CIO.

Gentlemen, we are pleased to have you with us today. Mr. Evans, I appreciate your willingness to be here and look forward to your comments.

Before I turn to you, I would ask if my Senator colleague from Illinois, Mr. Dixon, wishes to say anything.

Senator DIXON. Good morning, Mr. Chairman. I would just ask leave to put a statement in the record and I also have to advise the Chair that probably in a half an hour I will have to leave for a markup in another committee. It's nice to see you this morning.

STATEMENT OF SENATOR DIXON

I am pleased to be here this morning as the Senate Banking Committee continues its hearings on changes in the financial services industry. We have a distinguished group of witnesses before us, and I look forward to receiving their testimony.

As I'm sure everyone here knows, a subcommittee of the House Banking Committee has acted on financial services legislation, including provisions that put a national trigger on regional banking compacts, and that close the nonbank bank loophole, although with a grandfather date that is significantly different than the date in last year's Senate bill.

I look forward to quick action by the full House Banking Committee and then to early action on the House floor. I am delighted that the House is beginning to act. The House bill is by no means perfect. It does not, for example, provide for the badly needed expansion of bank asset powers. However, it is a real step forward; it provides some cause of optimism that Congress will enact comprehensive banking and financial services legislation this year, legislation that is long overdue.

As I have stated on many previous occasions in this committee, I believe Congress needs to address the changes that are occurring in the financial services industry. Last year's Senate-passed bill would have gone a long way toward dealing with many of the issues that desperately need attention. I again urge my colleagues to act quickly on a bill that is as comprehensive as last year's effort.

I know there are additional issues that the committee must address. Let me say again, however, that action on the issues contained in last year's bill should not be delayed. The new issues, while very important, should be handled in separate legislation.

The CHAIRMAN. Mr. Evans.

STATEMENT OF ROBERT B. EVANS, PRESIDENT, AMERICAN FINANCIAL SERVICES ASSOCIATION

Mr. EVANS. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am Robert B. Evans, president of the American Financial Services Association [AFSA], and I want to thank you very much for this opportunity to appear

again. We have already talked about this two or three times but we're going to try to keep making our point.

The CHAIRMAN. During the years we have talked about it you've become grayer and I've become balder and if I had a choice I wouldn't care what color; I'd take your color.

Mr. EVANS. I'll take it any way it comes.

We are particularly pleased to be able to come here since we have not been afforded the same opportunity on the other side of the Capitol and for some reason or another legislation is proceeding apace over there without regard to the interest of the very large credit granting industry so that we're very pleased to make our views known here.

I am just going to summarize the first few pages because I think we are all pretty well acquainted with our members. They are the diversified credit granting institutions of this country. They are the ones—Associates Corp. of North America—who started this whole nonbank bank thing; incidentally, with the complete approval of the Fed at that time. They seem to have kind of changed course since then.

And since that time, in addition to our traditional membership we have been pleased to add amongst our members Sears Roebuck and Co.—and I need say little more about their ventures into the financial services—and J.C. Penney more recently, and also Dreyfus Corp. So we are truly representative of a very broad spectrum of people engaged in the granting of consumer credit and also in taking of deposits.

This does not of course speak for the remaining members of AFSA who are numerous but have not yet put their toe in the banking water to see what's going to happen.

CONSUMERS NEEDS

We have decided since this is basically a consumer panel here today to say, well, what's in it for the consumer? That's the key question in any of this legislation and if it isn't good for the consumer—and we are now talking about consumer legislation, not commercial banking—it's bound to fail in the long run. So we believe that in establishing the legal framework on which the future of the financial services industry will be built the Congress obviously should above all keep in mind the interests of the ultimate users of those financial services.

What is it, after all, that consumers want from the institutions which exist to serve them?

Obviously, they want access. This implies convenience of time and place, a wide choice of products and services, and the varying price structures which go with them, from the cash management account concept which was originated by Merrill Lynch at one extreme, down to the no-frills basic transactional account service at the other.

The second thing the consumer wants, in order to make an informed choice, he would like understandable information about the products and services he proposes to buy. This is not always available today.

Finally, for any consumers, there is the concept of safety, which we call deposit insurance, and which like other services costs money. Nevertheless, many consumers will accept a lower rate of return on his deposits in order to secure such protection.

To the consumer, all three of these concepts—access, informed choice, and safety, at a price—are wrapped up in his concept of value, the final determinant of who gets his business. The decision of whether to buy at Sears or Saks, to bank at Bank of America or Fireside Thrift, is made—in the final analysis—because it's worth it. The point is, value judgments can only be made when choices are available.

Getting the consumer to the point where he is offered competing choices is a simple matter. As we have stated here many times, Mr. Chairman—to the point of boredom I'm sure—only competition provides choice and only freedom of entry ensures competition.

Consumers have already benefited significantly from the limited deregulation of financial services which has occurred over the last 3 or 4 years. We want to commend you, Mr. Chairman, and this committee for the very far-reaching and broad reforms which were passed during the past 4 years. They certainly probably saved some of the industry from going completely under water.

Now market rates paid on savings accounts at banks and thrifts have led to fierce competition to pay the consumer more for his investments. New variable rate savings instruments are gaining broad acceptance among consumers.

In addition, a healthy competition between banking and nonbanking companies has led to choices never before available to consumers.

Americans shopping for financial services, insurance, investments, and cash management accounts are finding that they can obtain them in retail stores and brokerage houses at more convenient locations and times. They now can do their banking at retail stores on weekends or in the evening and at ATM's 24-hours a day in locations other than those provided by traditional banking institutions.

New products are being developed almost daily to serve the consumer market. Debit cards, smart cards, and cash management accounts are examples of the many options offered to consumers which were only dreamed of a few years ago. These choices have been made available to consumers largely as a result of marketplace competition—competition which Congress should continue to encourage, not stifle.

Now AFSA recognizes that limited deregulation—which is what we have had so far—like most limited solutions, has not been without its drawbacks. While institutions have been allowed to pay higher yields on consumers' funds, Congress has not significantly expanded the allowable activities which would enable banks to make up for the increased cost of funds by offering such new products and services.

Consumers have justifiable concerns about the financial system. Recent well publicized runs and failures have raised questions about the safety of depository institutions, and certainly the question of deposit insurance is ripe for review.

Also, as competition for deposits increased, consumers find it more difficult to know with certainty the actual yield of the savings or investment choices they make. An ever wider array of depository products—with interest compounded in different ways—has made it more difficult for consumers to make well informed decisions.

Similarly, many consumers are uncertain as to the availability of their money once they have made a deposit. Consumers find themselves frustrated when some institutions are able to clear out of town checks in 2 or 3 days while others may take as long as 10 to 12 working days, and that situation exists here in Washington today.

AFSA believes that Congress now has a unique legislative opportunity to combine the best elements of financial services deregulation while answering consumer concerns.

CREATE CONSUMER BANKS

As you've heard before, Mr. Chairman, we believe that this can best be done by creating a new type of institution—the consumer bank. The competition which consumer banks will bring to the marketplace will assure consumers the widest possible set of choices of new, exciting financial products and services. And we believe that the Congress, in creating consumer banks, can ensure that consumers have the information and the certainty they need to make intelligent investment and borrowing decisions.

I have attached a copy of the AFSA consumer banking proposal to my testimony so that, with your permission, it can be part of your hearing record. Briefly, our proposal addresses safety and soundness concerns by requiring that consumer banks maintain a 9-percent capitalization level. It addresses the separation of the banking and commerce issue by putting a cap of 5 percent on the commercial lending activity of consumer banks. Also, it adopts the existing law governing loans to affiliates and restricting tying arrangements.

The centerpiece of the AFSA proposal links authorization for consumer banks to providing consumers with basic transactional services at a reasonable charge. As consumer lenders, AFSA members have a long commitment to serving consumers financial needs. Our companies are willing to put that commitment on the line and translate it into law.

Please note that, unlike some other proposals, we do not believe that such services should be mandated free of charge. We do believe, however, that ample precedent exists to provide a regulatory framework within which each consumer bank can commit to offer its customers low-cost, no-frills services which that bank can afford—for instance, highly automated consumer banks may be able to provide more than those not so equipped. But the key legislative goal here is, and should remain, to obtain a commitment from the institution, not to mandate a gift to the consumer.

Last year, when I spoke before this committee, AFSA was alone in advocating this concept of consumer banks. I am pleased that this year an AFSA member company, Sears, has proposed the creation of family banks which are similar in concept to the consumer

banks. The Sears proposal contains additional consumer oriented titles to make it easier for customers to understand the true yields on their savings accounts and to let them know how long they must wait before they have access to their deposits. Additionally, I am informed that the Consumers Union has proposed legislation which would allow the establishment of consumer banks.

Finally, Mr. Chairman, let me close with a suggestion. Perhaps we have looked at this issue too narrowly. Maybe we have been wrong to pursue the consumer bank solely as a vehicle to enable diversified institutions to engage in limited purpose banking. After all, if we incorporate into this proposal all the financial products and services a consumer could possibly want, shouldn't we—in fairness—make the consumer bank available to commercial bankers as well?

Then they, too, would have found the Holy Grail of the banking business—the level playing field. Of course, it would look more like a market than a playing field, but what more could a banker—or a consumer—wish for?

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

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American Financial Services Association

STATEMENT OF

ROBERT B. EVANS

PRESIDENT

AMERICAN FINANCIAL SERVICES ASSOCIATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

ON

CHANGES IN THE FINANCIAL SERVICES INDUSTRY

JUNE 11, 1985

Mr. Chairman, Members of the Committee, I am Robert B. Evans, President of the American Financial Services Association (AFSA).*

Thank you for this opportunity to appear and share AFSA's view of the future of consumer financial services with the Committee.

Because AFSA members serve consumers, my remarks will necessarily focus on the future benefits that consumers will receive through continued deregulation and the entry of new participants into the banking system.

AFSA member companies have obtained limited service banks to continue doing what they have for decades - providing consumer financial services. To AFSA members, the consumer credit business is not a stepchild or an adjunct to commercial lending, it is the cornerstone of our industry.

AFSA members have entered the consumer banking business to broaden their array of consumer financial services. Let me give you some examples:

- Associates Corporation of North America, a subsidiary of Gulf + Western, Inc. operates a national bank and a federal savings and loan association. Among the consumer services offered is a VISA card featuring an innovative rebate plan. A MasterCard is also offered in conjunction with several national retailers.

- Avco Financial Services, a subsidiary of Textron Corporation, operates a national bank in California which issues credit cards and offers real estate loans to its customers.

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* Organized in 1916, AFSA is the national trade association of financial services companies. AFSA represents over 535 companies operating more than 11,700 offices serving the public throughout the country. AFSA membership is highly diversified ranging from single small loan offices to national delivery companies engaged in unsecured direct lending, second mortgage lending, consumer banking, industrial banking and the financing of the sale of durable goods.

- Beneficial Corporation participates in the banking industry through a Delaware-based bank. Beneficial is among the 15 largest issuers of credit cards and is the largest issuer of premium "gold" MasterCards.

- Commercial Credit Company, a subsidiary of Control Data Corporation, operates a national bank in Delaware and state chartered institutions in Maryland, North Carolina, Ohio, Pennsylvania, and Texas, forming the basis of a national network offering a wide range of consumer services.

- The Dreyfus Corporation, a management company of mutual funds, owns a state bank in New Jersey and a national bank in New York. Dreyfus offers automobile loans to consumers at highly competitive rates.

- Household Finance Corporation, a subsidiary of Household International, owns a national bank and a federal savings bank in California which offer credit cards and second mortgage loans to their customers.

- J.C. Penney Company, Inc., operates a national bank offering a full range of consumer financial services in Delaware and is test marketing its products in other areas.

- Sears, Roebuck & Co., has operated one of the nation's largest savings and loans for over 25 years and has acquired a national bank in Delaware to launch its new nationwide third party credit card to provide consumers with an alternative to MasterCard and VISA.

- Teachers Services Organization, Inc. owns a national bank in Delaware, specializing in loans by mail and issues credit cards to school teachers, nurses and other professionals.

- Additionally, 20 states authorize industrial banking. Over 1,000 industrial banks, many with FDIC insurance, do business at over 2,000 locations, offering chiefly time deposits, consumers loans and some small business loans. They have deposits of $4.5 billion and assets of over $7.3 billion. Industrial banks have existed for 70 years.

These companies are offering innovative products and services to consumers at competitive prices. They serve millions of families by providing more than $35 billion in consumer credit on a full-time basis and, interestingly, these companies are the most experienced in delivering financial services through nationwide networks.

To deny consumers access to specialized institutions which serve the consumers, and to preclude well capitalized diversified companies from infusing capital into the banking system, is simply not realistic public policy.

Thus, AFSA members have an important role to play in financial services deregulation.

But our needs, and that of other providers of financial services, are subordinate to the issue: what's in it for the consumer?

We believe that, in establishing the legal framework on which the future of the financial services industry will be built, the Congress should, above all, keep in mind the interests of the ultimate users of those financial services. What is it, after all, that consumers want from the institutions which exist to serve them?

Obviously, they want access. This implies convenience of time and place, a wide choice of products and services, and the varying price structures which go with them, from the cash management account concept at one extreme, down to the no-frills basic transactional account service at the other.

Second, in order to make an informed choice, the consumer would like understandable information about the products and services he proposes to buy. This is not always available today.

Finally, for many consumers, there is the concept of safety, which we call deposit insurance, and which like other services costs money. Nevertheless, many consumers will accept a lower rate of return on his deposits in order to secure such protection.

To the consumer, all three of these concepts - access, informed choice and safety, at a price - are wrapped up in his concept of value, the final determinant of who gets his business. The decision of whether to buy at Sears or Saks, to bank at Bank of America or Fireside Thrift, is made - in the final analysis - because "it's worth it." The point is, value judgments can only be made when choices are available.

Getting the consumer to the point where he is offered competing choices is a simple matter. As we have stated here many times, Mr. Chairman - to the point of boredom I'm sure - only competition provides choice and only freedom of entry insures competition.

Consumers have benefited significantly from the limited deregulation of financial services which has occurred over the

last three or four years. Market rates paid on savings deposits at banks and thrifts have led to fierce competition to pay the consumer more for his investments. New variable rate savings instruments are gaining broad acceptance among consumers.

In addition, a healthy competition between banking and non-banking companies has led to choices never before available to consumers.

Americans shopping for financial services, insurance, investments and cash management accounts are finding that they can obtain them in retail stores and brokerage houses at more convenient locations and times. They now can do their "banking" at retail stores on weekends or in the evening and at ATMs 24-hours a day in locations other than those provided by traditional banking institutions.

New products are being developed almost daily to serve the consumer market. Debit cards, "smart cards", and cash management accounts are examples of the many options offered to consumers which were only dreamed of a few years ago. These choices have been made available to consumers largely as a result of marketplace competition -- competition which Congress should continue to encourage, not stifle.

AFSA recognizes that limited deregulation, like most limited solutions, has not been without its drawbacks. While institutions have been allowed to pay higher yields on consumers' funds, Congress has not significantly expanded the allowable activities which would enable banks to make up for the increased cost of funds by offering new products and services.

Consumers have justifiable concerns about the financial system. Recent well publicized runs and failures have raised questions about the safety of depository institutions.

Also, as competition for deposits increased, consumers find it more difficult to know with certainty the actual yield of the savings or investment choices they make. An ever wider array of depository products -- with interest compounded in different ways -- has made it more difficult for consumers to make well informed decisions.

Similarly, many consumers are uncertain as to the availability of their money once they have made a deposit. Consumers find themselves frustrated when some institutions are able to clear out of town checks in two or three days, while others may take as long as 10 to 12 working days.

AFSA believes that Congress now has a unique legislative opportunity to combine the best elements of financial services deregulation while answering consumer concerns.

We believe that this can be done by the creating a new type of institution - the Consumer Bank. The competition which Consumer Banks will bring to the marketplace will assure consumers the widest possible set of choices of new, exciting financial products and services. And we believe that the Congress, in creating Consumer Banks, can insure that consumers have the information and the certainty they need to make intelligent investment and borrowing decisions.

I have attached a copy of the AFSA Consumer Banking proposal to my testimony so that, with your permission, it can be part of your hearing record. Briefly, our proposal addresses safety and soundness concerns by requiring that consumer banks maintain a 9% capitalization level. It addresses the separation of banking and commerce issue by putting a cap of 5% on the commercial lending activity of consumer banks. Also, it adopts the existing law governing loans to affiliates and restricting tying arrangements.

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CONSUMER BANKING SERVICES ACT OF 1985

A BILL

To permit the establishment of consumer banks and to provide for access to consumer banking services, and for other purposes.

Be it enacted by the Senate and the House of Representatives of the United States of America in Congress assembled,

Section 101. That this Act may be cited as the "Consumer Banking Services Act of 1985."

Section 102. The Congress finds that -

(1) consumer access to banking services is a prerequisite to functioning in modern society; and

(2) consumers with modest transactional needs are entitled to access to basic banking services at a reasonable charge; and

(3) the Congress hereby establishes consumer banks to provide such services.

Sec. 103. Subsection 4(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1843(c)) is hereby amended by adding a new paragraph (15) to read as follows:

"(15) shares of any consumer bank as that term is defined in section 1841(j) of this title.".

Sec. 104. Subsection 2(c) of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841(c)), is hereby amended by adding a new sentence to read as follows:

"Notwithstanding the foregoing, the term 'bank' shall not include (i) any consumer bank as defined in subsection (j) of this section, or (ii) any industrial bank, Morris Plan bank, industrial loan company or similar institution, operated in the manner authorized by State law, that does not both engage in the business of making commercial loans and accept deposits that the depositor has a legal right to withdraw on demand."

Sec. 105. Section 2 of the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841), is hereby amended by adding new subsections (j), (k) and (l) to read as follows:

"(j)(1) 'Consumer bank' means any institution that would otherwise be a 'bank' under subsection (c) of this section, but that (i) does not engage in the business of making commercial loans, (ii) maintains a ratio of total capital to total assets of not less than 9 percent in three out of every four quarters in any calendar year, of which no more than 34 percent may be secondary capital, and (iii) establishes and maintains a consumer access program to provide transactional banking services at a reasonable charge, consistent with the safe and sound operation of such institution, for those consumers with modest transactional needs, which consumer access program shall conform to the requirements of regulations established by the appropriate Federal banking agency.

"(j)(2) The provisions of section 23A of the Federal Reserve Act, as amended, related to loans and other dealings between member banks and their affiliates, shall be applicable to every consumer bank in the same manner and to the same extent as if such consumer bank were a member bank; and for this purpose any company which would be an affiliate of a consumer bank, for the purposes of section 23A of the Federal Reserve Act, if such bank were a member bank shall be deemed to be an affiliate of such consumer bank. The provisions of this subsection shall not apply to any foreign bank having an insured branch with respect to dealings between such bank and affiliate thereof.

"(A) Any consumer bank which violates or any officer, director, employee, agent, or other person participating in the conduct of the affairs of such consumer bank who violates any provision of section 23A of the Federal Reserve Act, as amended, or any lawful regulation issued pursuant thereto, shall forfeit and pay a civil penalty of not more than $1,000 per day for each day during which such violation continues: Provided, That the appropriate Federal banking agency may, in its discretion, compromise, modify, or remit any civil money penalty which is subject to imposition or has been imposed under authority of this subsection. The penalty may be assessed and collected by the appropriate Federal banking agency by written notice. As used in this section, the term "violates" includes

without any limitation any action (alone or with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.

"(B) In determining the amount of the penalty the appropriate Federal banking agency shall take into account the appropriateness of the penalty with respect to the size of financial resources and good faith of the consumer bank or person charged, the gravity of the violation, the history of previous violations, and such other matters as justice may require.

"(C) The consumer bank or person charged shall be afforded an opportunity for agency hearing, upon request made within ten days after issuance of the notice of assessment. In such hearing all issues shall be determined on the record pursuant to section 554 of title 5, United States Code. The agency determination shall be made by final order which may be reviewed only as provided in subparagraph (D). If no hearing is requested as herein provided the assessment shall constitute a final and unappealable order.

"(D) Any consumer bank or person against whom an order imposing a civil money penalty has been entered after agency hearing under this section may obtain review by the United States court of appeals for the circuit in which the home office of the consumer bank is located, or the United

States Court of Appeals for the District of Columbia Circuit, by filing a notice of appeal in such court within twenty days from the service of such order, and simultaneously sending a copy of such notice by registered or certified mail to the appropriate Federal banking agency. The appropriate Federal banking agency shall promptly certify and file in such court the record upon which the penalty was imposed, as provided in section 2112 of title 28, United States Code. The findings of the appropriate Federal banking agency shall be set aside if found to be unsupported by substantial evidence as provided by section 706(2)(E) of title 5, United States Code.

"(E) If any consumer bank or person fails to pay an assessment after it has become a final and unappealable order, or after the court of appeals has entered final judgment in favor of the agency, the appropriate Federal banking agency shall refer the matter to the Attorney General, who shall recover the amount assessed by action in the appropriate United States district court. In such action the validity and appropriateness of the final order imposing the penalty shall not be subject to review.

"(F) The appropriate Federal banking agency shall promulgate regulations establishing procedures necessary to implement this paragraph.

"(G) All penalties collected under the authority of this paragraph shall be covered into the Treasury of the United States.

"(j)(3) The directors of any consumer bank may, quarterly, semiannually or annually, declare a dividend of so much of the net profits of the institution as they shall judge expedient, except that until the surplus fund of such institution shall equal its common capital, no dividends shall be declared unless there has been carried to the surplus fund not less than one-tenth part of the institution's net profits of the preceding half year in the case of quarterly or semiannual dividends, or not less than one-tenth part of its net profits of the preceding two consecutive half-year periods in the case of annual dividends: Provided, That for the purposes of this section, any amounts paid into a fund for the retirement of any preferred stock of any such institution out of its net profits for such period or periods shall be deemed to be additions to its surplus fund if, upon the retirement of such preferred stock, the amounts so paid into such retirement fund may then properly be carried to surplus. In any such case the institution shall be ogligated to transfer to surplus the amounts so paid into such retirement fund on account of the preferred stock as such stock is retired.

"(A) The approval of the appropriate Federal banking agency shall be required if the total of all dividends declared by such institution in any calendar year shall exceed the total of its net profits of that year combined with its retained net profits of the preceding two years, less any required transfers to surplus or a fund for the retirement of any preferred stock.

"(B) For the purpose of this section the term 'net profits' shall mean the remainder of all earnings from current operations plus actual recoveries on loans and investments and other assets, after deducting from the total thereof all current operating expenses, actual losses, accrued dividends on preferred stock, if any, and all Federal and State taxes.

"(j)(4) A consumer bank shall not in any manner extend credit, lease or sell property of any kind, or furnish any service or fix or vary the consideration for any of the foregoing, on the condition or requirement -

"(A) that the customer shall obtain some additional credit, property, or service from such consumer bank other than a loan, discount, deposit, or trust service;

"(B) that the customer shall obtain some additional credit, property, or service from a company that controls such consumer bank, or from any other subsidiary of such consumer bank holding company;

"(C) that the customer provide some additional credit, property, or service to such consumer bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;

"(D) that the customer provide some additional credit, property, or service to a company that controls such consumer bank, or to any other subsidiary of such consumer bank holding company; or

"(E) that the customer shall not obtain some other credit, property, or service from a competitor of such consumer bank, a company that controls such consumer bank, or any subsidiary of such consumer bank holding company, other than a condition or requirement that such consumer bank shall reasonably impose in a credit transaction to assure the soundness of the credit.

"(F) the appropriate Federal banking agency may be regulation or order permit such exceptions to the foregoing prohibition as it considers will not be contrary to the purposes of this chapter.

"(k) The terms 'total capital' and 'secondary capital' as applied by the appropriate Federal banking agency for the institutions which they regulate shall not differentiate between consumer banks and other institutions which are regulated by the agency.

"(1) The term 'commercial loans' does not include: (i) loans to natural persons primarily for personal, family, or household purposes, whether directly, indirectly or through the use of leases; (ii) credit to finance the inventorying of goods generally being sold to such persons; (iii) the purchase of or investment in retail installment sales contracts and accounts receivables, and the financing of sellers or dealers in connection therewith; (iv) loans for charitable purposes; (v) loans secured by residential real property; (vi) loans to natural persons through use of credit cards or similar means of access; (vii) loans to small business concerns; or (viii) investments such as commercial paper, certificates of deposit, bankers acceptances and similar money market instruments, the extension of broker call loans, the sale of federal funds, the deposit of interest-bearing funds, mortgage-backed securities, obligations of the United States and local and state governments, or agencies and instrumentalities thereof, and such other similar types of investments as may be permitted by the institution's primary regulator. An institution shall not be deemed to 'engage in the business of making commercial loans' if the aggregate principal amount of its outstanding commercial loans does not exceed 5 percent of the institution's total assets in three out of every four quarters in any calendar year."

Sec. 106. Section 7 of the Bank Holding Company Act of 1956 is amended at the end thereof by adding the following new sentences:

"No state shall enact any law or regulation which limits any rights granted to a consumer bank by this Act or restricts entry by a consumer bank to any greater extent than for any federally-chartered institution. No state may limit or restrict the activities of any person because that person controls or is affiliated with a consumer bank."

The CHAIRMAN. Thank you, Mr. Evans.

CREATION WOULD NOT VIOLATE BHCA

Chairman Volcker in his testimony a few weeks ago claimed that the creation of consumer banks violates the most basic premise of the Bank Holding Company Act, the separation of banking and commerce.

How do you respond to his testimony?

Mr. EVANS. Well, it's true that commercial banking and commerce were separated in the banking acts of the early 1930's. I might say that in a review of the record creating those acts there's very little reason given. There was a great deal of hysteria, as you know, concerning the alleged improprieties in the conduct of the banking business between the investment bankers and the commercial bankers and the lumping together was seen as an evil which had to be separated. This has not always been true in our country and there were no reasons given at the time.

Senator Glass and Mr. Steagall used this as a whipping boy simply to pass the legislation.

But let's look directly at what we are talking about here. It is not the commercial banking that we propose to combine with commerce. We are not proposing that Citibank and Exxon be made into one institution. We are simply talking about the doing of a consumer banking business which has actually none of the overtones or the dangers which would be associated with large-scale commercial enterprises becoming part of the commercial banking system.

Where would the possibility exist, for instance, for broad-scale preferential treatment in the granting of consumer loans as opposed to commercial loans?

So we think that issue is largely a nonissue, and if you will notice, Chairman Volcker has never offered any kind of explanation or reasoning for his rationale. I understand he doesn't have to give it, but some of us might be curious as to just why he says those things.

The CHAIRMAN. If we create these consumer banks as you suggest in your testimony, what would be the effect on the Federal insurance fund?

Mr. EVANS. Well, let me answer that in three quick ways. No. 1, I don't believe the effect will be adverse. I think it actually would be helpful. Consumer assets are among the most secure and fungible in the entire banking business. You will note when Continental got in trouble the first thing that was sold out of their portfolio was their entire credit card base; they had tremendous competing bids for that. A number of our members bid on it.

Consumer assets type base business is simply one of the long demonstrated history of being secure in the sense of repayment. You cannot look at any one consumer loan and say with certainty it is going to be repaid, because this would mean no consumers get in trouble. But since the 1930's, even during the depression, consumer portfolios—as opposed to individual loans—have always been repaid for the most part and have not jeopardized the safety or soundness of any well-managed institution.

Let me say this, though, about the deposit insurance, Mr. Chairman, if I could just elaborate a little further. We do feel the whole question of deposit insurance is at the core of banking reform, that you will not have meaningful reform until you address this issue, and that's simply because the present system, as we've said before, misprices risk. You're subsidizing the banking system. You are encouraging inept and inefficient bankers to make less than fully market oriented credit decisions.

After all, when you can play with somebody else's money and you can be relieved of the responsibility of repaying back that money because Uncle Sam is going to do it if you don't, it's a system which is calculated to produce the kind of results we have seen recently.

Now a lot of people have urged that a price or risk-related insurance premium be devised so that banks that are good would pay less than banks that are bad, and there may be something to that. But I don't think it is within the realm of possibility for Government to make this kind of marketplace decision about bank risks; there is an inherent conflict there between having a Government official judge a bank which is required to make risk decisions when the Government official himself is charged with protecting the Treasury and charged with the safety and soundness. What will he opt for in time? It will be the lowest possible risk and that will place a terrible burden on the banking business.

RISK-PREMIUM UNDERWRITING

I won't go into it any further because it takes tremendous elaboration, but at the very time when private insurance is seen as being on its way out and has no role in this economy, I would like to say it's probably the very time we should be looking at some combination of Federal and private insurance in this field, keeping the Federal ultimate guarantee in place but possibly farming out the risk-premium underwriting and handing out insurance to a private insurance system.

Only in that way are we going to get the market disciplines built into it. We would be glad to submit something more on this, but it's the kind of thing that I think will be the subject of other hearings. We do feel it's very important and would like to comment on it later if it does come up because without it we see terrible obstacles to any kind of meaningful bank reform.

The CHAIRMAN. I'm one of those who has been advocating risk-related premiums and I understand it's difficult to decide where those categories would be and all of that, but I simply can't accept the fact that we can't work out a system to do that. I think money becomes a very powerful tool for reform. We've passed all kinds of other regulations trying to direct people to do things and I just can't believe it wouldn't be helpful if it was going to cost them quite a bit more if they wouldn't clean up their act or reconsider some of the loans that they otherwise would have made but will not if somebody is going to say, hey, that's a loan that is not a good one and you're going to pay for it.

Mr. EVANS. I agree with you 100 percent, Mr. Chairman. I think what I am referring to here is the way in which that can be made to work without surrendering the best features of both systems.

The CHAIRMAN. I understand. I'm just saying that I hope that you're not unwilling to take a look at trying to devise such a system. I've said here in the committee several times that I wish I could buy life insurance at the same rate as my 27-year-old son, but I can't. My risk is greater. And my 18-year-old son—boy, I'd hate to pay what he pays for his automobile insurance because of his age group's driving habits.

Mr. EVANS. That's correct.

The CHAIRMAN. And I think it's a shame as we look at the condition of the banking system now that I'm constantly asked the question, what shape is the banking system in? The system is in very good shape. There are lot of go-go operators and several of them, if you would analyze, in most of the bank failures. In the 79 bank failures last year, it wasn't because the system was weak. In most of those cases, there was very, very bad management practices. And as you look at those examinations, those particular institutions would have been paying a lot higher premiums for their FDIC or FSLIC insurance.

Mr. EVANS. Absolutely.

The CHAIRMAN. And I don't see why the good, conservatively run consumer oriented institutions in this country should subsidize the people that are off making some of these very bad management decisions and in some cases fraudulent decisions.

So I certainly think it's an area we have to pursue and try to devise some type of a system to encourage people to run their institutions in a more conservative manner.

Mr. EVANS. That's certainly the way our industry has had to do it over the years. Instead of having a Government regulator look at us, we've had Standard and Poor's and Dunn all assigning ratings to our bonds and our credit instruments, and if they aren't there, we pay more; and if they are good, we've done a good job and we've got our ratios in line and our loss experience is good, then we get the most favorable credit ratings. And the same device can be incorporated into the Federal system. I think it should be a combination of the best of the private area and the best of Government. I think there's room for that kind of combination.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Mr. Evans, on page 3 of your testimony you say:

> In order to make an informed choice, the consumer would like understandable information about the products and services he proposes to buy. This is not always available today.

TRUTH-IN-SAVINGS BILL

In order to help consumers have understandable information about the savings services of financial institutions, do you think Congress should enact a truth-in-savings bill requiring such institutions to state their savings interest rates in a uniform way?

Mr. EVANS. If I can be allowed to waffle on that, Senator Proxmire, I would say yes, but let's keep it simple. A lot of proposals

have come out and the most original and simplest one I've seen requires the statement of the savings rate in terms of a daily rate; it may be possible to do that.

Senator PROXMIRE. What's wrong with making it conform to the truth in lending that we have for lenders?

Mr. EVANS. I'm sorry. I missed the first part of that.

Senator PROXMIRE. We have the Truth-in-Lending Act that's been on the books now for 16 years for lenders. Why not have the same apply here?

Mr. EVANS. I think a similar concept—I would not like to see it as complicated as the Truth-in-Lending Act which we now have on the books. I could see that a certain—in fact, Senator Douglas, as you well know, when he first proposed truth in lending—did have in mind a simple statement of the rate without all the elaborate bells and whistles that we have added to this thing. I'm not condemning the product and I understand it was the product of this committee and Congress that finally came out.

The CHAIRMAN. You can condemn it because Senator Proxmire has been one of the leaders who's been trying to simplify it.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. EVANS. We were privileged to testify on that and we probably would have done it differently, but——

Senator PROXMIRE. Well, the Federal Reserve Board found that an overwhelming majority of people now understand what the interest rates are who didn't before, and this is in all categories of income, including people who have very low income, and it's been a real service. You can really compare the cost of borrowing now where you couldn't before.

Mr. EVANS. Right, and we support that. We support what you are talking about with the caveat I would say if we can keep it from becoming another regulatory—I won't call it a Rube Goldberg device—but we've suffered with it over the years and at great expense. Much of it I think was probably not necessary, but no one is perfect.

Senator PROXMIRE. You seem to be pulling us in a little different direction than we have been going. Maybe you're right in doing it. Most of the banking legislation over the last 10 years has tended to eliminate distinctions between different kinds of financial institutions. The major reason was to promote diversity and avoid overspecialization. Your consumer bank proposal would create still another type of specialized institution.

Isn't that a major step backward?

Mr. EVANS. No, I can't agree with the premise, Senator Proxmire. I think it's the other way around, what we're trying to fashion here, and that's why I kind of had that tongue-in-cheek ending in my statement, that if we were to devise a true consumer banking vehicle, why shouldn't it be available to everyone, including the commercial banks themselves, to be run on the same basis where everyone is on an equal competitive footing, offers the same consumer products whether it's a thrift, whether it's a bank, whether it's a retailer, has the same powers, the same ability to serve the consumer, and has the same duties and responsibilities to the public in return. It seems to me that that's what we're looking for.

Senator PROXMIRE. What effect would your consumer bank have on the allocation of credit for consumer and business purposes? It seems to me that it would tend to steer credit away from the business sector, particularly the small business sector and independent business sector, and into the consumer sector.

Mr. EVANS. If you assume a finite pool of capital, that may be true; but I think it's pretty apparent today that there's no shortage of capital in this country. It's the price that perhaps people object to. In that respect, I don't think consumer lenders are any more acquisitive of capital than the Government or people that engage in large corporate reorganizations. I think our capital is used pretty efficiently and after all, if the consumer doesn't have the wherewithal to buy the goods, it doesn't make any difference how much capital is allocated to business to produce them. I think that's part of the same equation. If you want to produce, you've got to consume. I don't think there should be any public policy saying—and this is where we may disagree—saying banks, or small businesses, or corporate reorganizations, or anyone else should have a particular share of the capital. Let the marketplace determine the price. I don't think it's demonstrated that small business is having trouble getting capital, except perhaps at the price they want.

PROPOSING DEPARTURE FROM PRESENT SYSTEM

Senator PROXMIRE. Well, the staff suggests to me that if you create a specialized institution dealing exclusively with consumer credit, isn't that changing the rules in the marketplace? Isn't that shifting? You say we have an efficient system now. I think we do. You're proposing a departure from the system we have now. Maybe you're right in doing it, but you're proposing a change which would tend, it would seem to me to steer capital toward the consumer and away from independent businesses.

Mr. EVANS. Well, there's no way—and if you're going to talk about getting capital for consumer purposes, our members have never sourced their funds through deposits—most of our members—GMAC, for instance, if it were a bank, would be one of the largest banks in this country—in the world, also. In 1983, it earned over $1 billion net. It's a very profitable, sound, large financial institution. But, it gets all of its capital in the marketplace, not from deposits. That capital has to come from someplace. It sells its commercial paper. It issues long-term debt. It uses whatever debt instruments are available to accumulate capital. The fact that it does that through the market and not through deposits is really not significant today. Bank deposits end up sooner or later either being lent out by the bank that has them or being deposited in other banks or put in the form of an asset by buying commercial paper.

I don't see that deposits have any sancrosanct nature about them so that they can only be used in a certain way. Our members will get capital one way or the other and they will lend it as long as there's consumer demand.

What we are really talking about here is getting into the mainstream of providing consumer services. That means being part of the payment system. If we were to issue a debit card and give other

liability services to the consumer—and the consumer could care less today—he thinks in terms of account. One day he's banking with you and the next day you're banking with him, depending on whether he has money in the bank or whether he's in a net debtor position. He wants the ability to access these products quickly and conveniently. If our members are providing half of it, they feel they are going to be disadvantaged. We serve a very large spectrum of the consumer public, a large spectrum of the consumer public that's not in the upper echelon, like Merrill Lynch, Chase, and Citibank that are serving the very upper echelon consumer.

Sears, Household, and Beneficial are serving that middle 60 percent, basically not the 20 percent on the bottom or the 20 percent on the top. And we feel that those consumers deserve every bit as much a shot at traditional consumer financial services and new products as they will come electronically, and that's where it's all going to come from. We simply have to be part of this delivery system, but the deposits are really secondary in terms of getting funds. Deposit taking is necessary simply because we have to provide the consumer this service.

Banks and S&L's are having a terrible time right now deciding how to make money on deposits because their margins have disappeared. I'm on the board of Perpetual American Bank and I can tell you we're doing well and we're making money, but it's not coming from the traditional get $5 in the account, mark it up x percent and lend it back out for a profit. No one is doing that today. It's simply become a matter of handling funds for the consumers, charging fees for services, brokering services, creating products and services that can be charged for discretely, because the interest rate margin is not where you make the money.

Senator PROXMIRE. Thank you very much.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No questions.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Evans, you mention on page 5 of your testimony that the consumer bank and the proposed Sears family bank is similar in concept. You state that the Sears plan includes "additional consumer oriented titles to make it easier for customers to understand."

What are other differences between the consumer bank and the family bank?

OPERATION OF CONSUMER BANKS

Mr. EVANS. The disclosure items are the principal ones, Senator Sasser. They have just essentially added those two additional items to our proposal and I think they wanted to let the public know that they were willing to go the full mile on this and put it in writing and commit themselves to these kinds of disclosures. But the banks in all respects have the same powers, the same consumer products. There's virtually no difference between them.

And we ourselves, in the AFSA bill, have committed to try to provide consumer transactional account services at the lowest possible cost. We are not saying they should be given away, but we

have a precedent in the Community Reinvestment Act where each bank can commit to the supervisory regulatory agency what it thinks it can do to accommodate this need in the community. We think that's the best way. So our members, after a great deal of debate, made what we thought was a rather large commitment to do this for the consumer, and I'm sure they will back it up.

Senator SASSER. How would you describe the differences in theory and then in practice among your proposed consumer bank, the Sears family bank, and the so-called nonbank bank that's been the subject of such dispute in the courts and has been a bone of contention all across the country? How would you describe, first, the difference in theory and then the difference in practice?

Mr. EVANS. Well, taking the nonbank bank, which is the vehicle we are using now—the Associates was the first one to have one in 1978—they obtained a bank charter or actually an existing bank with the approval of the Comptroller and the knowledge of the Fed at that time. I think the Fed didn't see what was coming and thought nothing much about it. Essentially, what the Associates wanted to do was to take its Master and Visa cards and issue them through a bank which they owned as opposed to doing it through a contract with a commercial bank. And that has been the case virtually in most of our members obtaining a nonbank bank charter and that is for two purposes—one, to issue the credit card; two, is to export rates from States such as Delaware and California where the rates are higher. The national banks, as you know, can issue a credit card and charge the rate of the State of origin anywhere in the country. Finance companies and retailers cannot do that. So, without interest rate deregulation or preemption at the Federal level, this has been one reason why they have gone to the nonbank vehicle. But primarily it's the issuing of a new product which has been very successful. Beneficial is one of the very largest credit card account holders in this country today. It's in the top 12, I believe, simply in the space of a few years. Their products are a little different. They are well received. They're competitive and people like them, and that's what we're trying to get at in our consumer bank proposal. Give us a chance to do business with the consumer—give Sears, Penney's, Dreyfuss, Household—and they will bring the competition, the access, the choice, the new products to the consumer that the consumers want. We will commit at the same time to disclosure and to the provision of bare bones or no-frills transaction account services which has become somewhat of a perplexing problem for low-income consumers.

We think we can do this. We know the problems we will face but we will be able to handle them on an electronic basis. It's no secret that we're not being altruistic; we just feel it's part of doing business. I may not have answered your question, it's such a broad one, Senator Sasser, but the key thing is that we're zeroing in on the retail consumer side of banking. Our members do a lot of commercial business. They do not need banks to do that. Indeed, down the road, John D. Heimann said many banks may well be tempted, if there's deposit insurance reform, to give up their bank charters and run their commercial business as a commercial finance company. They simply may not be able to afford the kind of deposit insurance rates that are going to be assessed in the marketplace.

That's a conjecture, but that's a very able and respected person who's saying that; Walter Wriston has made such a point in the past.

So we may not be too far away from that which is coming down the road and that is where most of the consumer banking will be done—consumer banking through consumer banks and commercial banking through commercial banks. Look at one of our members, G.E. Credit, it's a very, very large company and it takes no deposits; yet it is able to finance many billions of commercial loans and leases in this country through its sheer ability to raise funds in the marketplace.

So we're in a revolution and we can't see where it's coming out, but we do believe the consumer should have the same benefits coming out of all institutions, the same products, and the same services. This will bring competition to the forefront and the emphasis will then be on what we can do for the consumer and not what he can do for us.

CONSUMER BANKS WILL BE SECURELY FUNDED

Senator SASSER. Well, in your testimony you indicate that consumer banks will maintain a 9-percent capitalization and that they will have a 5-percent cap on commercial lending activities. Now these features suggest that the so-called consumer bank will be securely funded and that they would not be competitive with the commercial lending activities of local banks.

Could these aspects of your proposal be further broadened as some have suggested to provide for joint ventures or joint operations of these consumer banks with existing local banking institutions? We might end up there with the local community having the ultimate resources of a consumer bank along with melding that with a local banking matching experts and skills which many say now exist in our country's independent banks. Is that just a pipedream or would that be possible?

Mr. EVANS. I think what I sense that you are zeroing in on, Senator Sasser, is something of a phenomenon that is coming about, and in fact Mr. Heimann in the very speech I just alluded to brought this up, and that is that the independent bank or the local community bank is not going to be run out of business. It will still be there. It will be run by Mr. or Ms. Jones who knows the local market well. What that bank will receive perhaps from a regional bank, or from a money center bank, or even a retailer or finance company is expertise in communications, electronic data processing, card servicing, insurance, investment, vehicles, and securities—all of that will be provided under contract. It's being done today for local banks who can't maintain these facilities for themselves and, indeed, the consumer banking vehicle would be one way in which much of the national benefits of consumer banking, being electronic distribution of funds and receipt thereof, could be made available to every bank in this country.

Senator SASSER. Mr. Chairman, I don't have any further questions at this time. Thank you.

The CHAIRMAN. Thank you.

Senator Gorton.

Senator GORTON. No questions.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. I'd just like to ask one question. Not having heard all your testimony, I apologize.

What evidence do you have to show the present banking system is not serving the consumer needs or that it could not serve them in ways that would not create the necessity for creating a consumer bank?

Mr. EVANS. I suppose I could recite, Senator Cranston, a number of instances anecdotally which might tend to support my view, but I would rather rest our argument on the basic economic premise that competition is the way to ensure that consumers will get the most for their money and the only way to ensure competition is to have free entry.

If you're going to restrict the number of players in any given market, then it's inevitable that without competition that the product or the service is going to decline, the quality of the product and the service will fall off and the price will increase. And we believe that the case, if there is any today in the marketplace, is to allow other people to come in to play. Furthermore, we're already there. We are already providing a lot of consumer services.

What we are saying is, permit us to get in on the transaction account end of it so that we can deliver complete consumer services and not just half a loaf. One way or the other, our members will find a way to do this, but I think it's to the benefit of everybody else that we come into the tent, so to speak, and operate within the existing rules and not be forced to the outside where we have to set up our own payment system and a separate system for doing consumer business, because it will be done. These are very large companies that are going to find a way to do it—American Express, Sears, Merrill Lynch, Penney's, and our remaining members are already working on ways, and essentially it's a communications issue, an electronic issue, in which they will deliver these services. It would be much easier and we think much more efficient in the long run if these services were integrated in one system and let competition then provide the benefits.

I don't want to use the typical example of the small town with the one bank and all that sort of thing, but we know from our own experience where there's a lack of competition what can happen, and I think this is a demonstrated fact.

Senator CRANSTON. Thank you. That's a good broad answer to a good broad question. Thank you.

Mr. EVANS. Thank you.

The CHAIRMAN. Thank you, Mr. Evans. We appreciate your testimony today.

Mr. EVANS. Thank you very much.

The CHAIRMAN. Next I'd like to invite Mr. John T. Sutton to the witness table. Mr. Sutton, we're happy to have you with us today and please proceed.

STATEMENT OF JOHN T. SUTTON, CONSUMER CREDIT ADMINISTRATOR, COMMONWEALTH OF VIRGINIA; ON BEHALF OF THE NATIONAL ASSOCIATION OF CONSUMER CREDIT ADMINISTRATORS

Mr. SUTTON. Thank you, Senator Garn. Nice to be here. I'm not sure how I got in on this but our president, Jack Carlson, called me last week and said, "Will you fill in for me," because his father is very ill, so I'm filling in.

Mr. Chairman and other distinguished committee members, my name is John T. Sutton, Jr., second vice president of the National Association of Consumer Credit Administrators and deputy commissioner, bureau of financial institutions for the Commonwealth of Virginia.

The National Association of Consumer Credit Administrators, formed in 1935, is an association comprised of all 50 State consumer credit supervisory departments, plus the Dominion of Canada and the Commonwealth of Puerto Rico. Our members are responsible for licensing, regulating, and supervising over 3,000 consumer credit organizations. This industry ranges from the national conglomerate financial services organizations with multi-State operations—some with deposit taking authority—to the small neighborhood single office finance company.

I will speak briefly today on changes in the financial services industry, some specific areas of concern and also provide you with our views on deregulation, consumer banks, first mortgages, and consumer protection issues.

MARKET RESPONSE TO CONSUMER DEMAND

It's obvious that the financial services industry is now in its current form as a market response to consumer demand. This broad industry which provides commercial banking, savings, securities, home loans, and insurance services with blurring lines of definition is in the business of serving the financial needs of customers. And these customers have shown they aren't interested in fine historical distinctions but want someone to cater to their present needs and desires.

Thus the arena is in place for this new round of competition, and we foresee that the targeting of market segments will become the primary means of competing. Successful competitors will focus on particular segments. Forces for change will impact all competition with impacts felt first by the smallest; least technologically developed and with fewest innovative products. Those institutions that cling to the past will decline. The financial services industry over the next decade will be profitable to those who survive; dangerous for those who don't plan strategically, the proving ground of new product and service concepts, and the ultimate test of the wisdom of deregulation.

We recognize that deregulation is clearly making it easier to provide improved and integrated services to all types of customers. In addition to the philosophical and political arguments for easing many regulations and removing restrictive laws, there's a compelling practical reason: competition.

Adam Smith foresaw that the marketplace was truly a regulatory agency that could regulate most economic activities with equal speed, effectiveness, and freedom.

However, for deregulation to continue to be effective requires continuously monitoring its market benefits and ensuring adequate disclosures—that is truth in lending and truth in savings—to consumers.

Nonbank banks or consumer banks operate in 20 States under the name of industrial banks, thrift and loans, industrial loan, or Morris Plan banks. These financial organizations primarily owned by nonfinancial institutions have had a sound financial history. The asset base provided by short-term consumer loans has proved to be sufficiently diversified to provide adequate liquidity and enable this industry to quickly respond to changing market conditions.

While California, Colorado, Nevada, and other States maintain a private guaranty option for deposit coverage, most of their consumer banks now have FDIC coverage. This industry provides an essential marketplace with a diversity of services and products desired by the consumer.

However, this industry is restricted in most States from engaging in commercial lending and other services identified with commercial banking. It is on this basis that we do not believe that this specialized segment of the financial services industry should be subject to the requirements of the Bank Holding Company Act.

It's ironic that first lien mortgage loans are the single most important financial transaction most consumers ever make and yet they are the least regulated. We set rates, impose substantive contract term prohibitions, require cure periods and notice on default, and even go so far in some States as to require plain language documentation in small loans and credit sales, yet when it comes to rates, terms, additional charges, protections on default, and basic understandability of the transaction in the case of first lien mortgages, it's almost a no-holds-barred situation. Consumers, literally, have more substantive protections, and more Government agencies to help them, when their loans are small than when they are large.

The case is even worse for mortgage companies, which in most States are still unregulated. Although technically under the FTC's jurisdiction as a creditor, and under the FHLBB's for alternative mortgage transaction regulatory purposes, they are not subject to the kind of examination for truth-in-lending compliance that financial institutions are by the FDIC, FHLBB, NCUA, and State regulators in some States.

FIRST-LIEN MORTGAGE REGULATION

Specifically, our concerns about first-lien mortgage regulation fall into four areas: mortgage origination, mortgage servicing, fees and charges, and Federal regulatory preemption.

Despite our concern about inadequate regulation, mortgage lending is fraught with paperwork. There is so much now that the average consumer is overwhelmed so much so that he or she is disinclined to read anything.

Informed consumer participation in the process presupposes and demands on ability to comprehend the documents involved. Mortgage documents are among the most complicated, however, because of some of the archaic phraseology that accompanies the law of real property transfers. The result is the most significant consumer financial undertaking being the most incomprehendible.

Regulation Z is the only cost comparison tool consumers have in credit shopping. Purposely, regulation Z was to preempt the field so that only one, uniform system of disclosure would prevail that consumers could use reliably in comparing one credit source to another. Regrettably, regulation Z enforcement has declined at the Federal level considerably.

With new actors and keen competition, there is also great competitive pressure to develop and push new products. In some companies there is clearly inadequate training of new staff and/or inadequate supervision of that staff, such that significant disclosure violations are proliferating. One administrator reported that a mortgage company made literally hundreds of loans in which the only finance charge listed was the prepaid finance charge.

We have seen the most problems in this area probably because unlike the disclosure area consumers can realize when someone has screwed up and they now have a tax lien on their property or their homeowners insurance has been canceled. We have received innumerable complaints about these kinds of experiences. Problems have arisen because mortgages have been repeatedly sold and the new servicer doesn't realize when tax or insurance payments are due. More often, however, problems have arisen because the servicer is disorganized. We have also witnessed property insurance being canceled and countless cases of surly or unresponsive treatment when calls or letters have been initiated to try to resolve these problems the consumer had no hand in creating.

We have also witnessed unexplained increases in mandated escrow balances due to dubious and self-serving escrow analyses performed by the mortgage servicer. People have been required to pay more into escrow for tax and insurance increases that have not occurred. It's great for the servicer who pays no interest—in 38 out of 50 States at least—on this huge sum of money. The consumer is virtually powerless to do anything about this as he—generally unwittingly—signed the mortgage which contracted for the lender's right to collect anticipated tax and insurance funds.

One way to curb abusive escrow buildups is to require interest to be paid on such funds as is the case in 12 States.

With the growth of the sale of mortgages in the secondary market has come the proliferation of fees and charges, some of them of a dubious nature. We recognize that the secondary market is a valuable development for consumers generally in that it makes more mortgage money available. It also, necessarily, raises costs to the consumer because more middlemen are now involved, each taking his cut along the way. I think the imposition of these extra charges is now worthy of scrutiny, however, at the national level, to evaluate how necessary and bona fide they are.

While Garn-St Germain is history now and most States, by default, have lost the right to assert their own regulatory prerogative in mortgage lending as the 3-year override opportunity has almost

expired, an effort should at least be made to see adequate Federal enforcement in the area they have preempted. Ideally, the preemptive scheme should be modified to give the States some meaningful role in the formulation and enforcement of substantive regulation of first-lien mortgage activity.

RULE OF 78'S

The last item I wish to address is the use of the rule of 78's. This method of calculating charges has been identified by State administrators as the largest source of complaints. The rule has a number of objectionable features. For one thing, it's difficult to understand, even for lenders. For another, its usefulness is outdated in this age of computers. The rule was acceptable for the short-term loans during the 1930's, but it badly distorts the amount of interest due on prepayment of today's longer term loans.

More important, the borrower always comes out on the short end of the rule of 78's, usually without realizing it. The rule's hidden penalty has been the focal point of criticism by consumer activists, State administrators, and even some lenders have admitted it's unfair. Some States such as Idaho, California, Oregon, Arizona, and Vermont have repealed the rule of 78's and NACCA has made the universal repeal of this method its primary issue of reform for 1985–86.

It is one of the stated purposes of the National Association of Consumer Credit Administrators to increase the usefulness and efficiency of the State departments having supervision over consumer credit agencies and promote the general welfare of the consumer and the consumer finance industry cooperating with other organizations, whether public or private, to secure uniformity of supervisory procedures and of the laws administered by the agencies in the various States.

Thank you for the opportunity to present our views before this distinguished committee.

[The complete prepared statement follows:]

TESTIMONY

OF

JOHN T. SUTTON, JR.
SECOND VICE-PRESIDENT

NATIONAL ASSOCIATION OF CONSUMER CREDIT ADMINISTRATORS

INTRODUCTION

Mr. Chairman, my name is John T. Sutton, Jr., Second Vice-President of the National Association of Consumer Credit Administrators and Deputy Commissioner, Bureau of Financial Institutions for the Commonwealth of Virginia.

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I will speak briefly today on changes in the financial services industry, some specific areas of concern and also provide you with our views on deregulation, consumer banks, first mortgages, and consumer protection issues.

It's obvious that the financial services industry is now in its current form as a market response to consumer demand. This broad industry which provides commercial banking, savings, securities, home loans and insurance services with blurring lines of definition is in the business of serving the financial needs of customers. And these customers have shown they aren't interested in fine historical distinctions but want someone to cater to their present needs and desires.

Thus the arena is in place for this new round of competition, and we foresee that the targeting of market segments will become the primary means of competing. Successful competitors will focus on particular segments. Forces for change will impact all competition with impacts felt first by the smallest; least technologically developed and with fewest innovative products. Those institutions that cling to the past will decline. The financial services industry over the next decade will be profitable to those who survive; dangerous for those who don't plan strategically, the proving ground of new product and service concepts and the ultimate test of the wisdom of deregulation.

De-regulation

We recognize that de-regulation is clearly making it easier to provide improved and integrated services to all types of customers. In addition to the philosophical and political arguments for easing many regulations and removing restrictive laws, there's a compelling practical reason: competition.

Adam Smith foresaw that the market place was truly a regulatory agency that could regulate most economic activities with equal speed, effectiveness and freedom.

However, for de-regulation to continue to be effective requires continuously monitoring its market benefits and insuring adequate disclosures (i.e. truth in lending and truth in savings) to consumers.

Consumer Banks

Non-bank banks or consumer banks operate in 20 states under the name of industrial banks, thrift and loans, industrial loan or Morris Plan banks. These financial organizations primarily owned by non-financial institutions have had a sound financial history. The asset base provided by short term consumer loans has proved to be sufficiently diversified to provide adequate liquidity and enable this industry to quickly respond to changing market conditions.

While California, Colorado, Nevada and other states maintain a private guaranty option for deposit coverage most of their consumer banks now have FDIC coverage. This industry provides an essential marketplace with a diversity of services and products desired by the consumer.

However, this industry is restricted in most states from engaging in commercial lending and other services identified with commercial banking. It is on this basis that we do not believe that this specialized segment of the financial services industry should be subject to the requirements of the Bank Holding Company Act.

First Mortgages

It's ironic that first lien mortgage loans are the single most important financial transaction most consumers ever make and yet they are the least regulated. We set rates, impose substantive contract term prohibitions, require cure periods and notice on default, and even go so far in some states as to require plain language documentation in small loans and credit sales, yet when it comes to rates, terms, additional charges, protections on default and basic understandability of the transaction in the case of first lien mortgages, it's almost a "no holds barred" situation. Consumers, literally, have more substantive protections, and more government agencies to help them, when their loans are small than when they are large.

The case is even worse for mortgage companies, which in most states are still unregulated. Although technically under the FTC's jurisdiction as a "creditor," and under the FHLBB's for alternative mortgage transaction regulatory purposes, they are not subject to the kind of examination for truth-in-lending compliance that financial institutions are by the FDIC, FHLBB, NCUA and state regulators in some states.

Specifically, our concerns about first lien mortgage regulation fall into four areas: mortgage origination, mortgage servicing, fees and charges and federal regulatory preemption.

Mortgage Origination

Paperwork Overkill - Despite our concern about inadequate regulation, mortgage lending is fraught with paperwork. There is so much now that the average consumer is overwhelmed so much so that he or she is disinclined to read anything.

Plain Language - Informed consumer participation in the process presupposes and demands an ability to comprehend the documents involved. Mortgage documents are among the most complicated, however, because of some of the archaic phraseology that accompanies the law of real property transfers. The result is the most significant consumer financial undertaking being the most incomprehendible.

Disclosure Violations - Poor Regulatory Supervision of Major Actors - Regulation Z is the only cost comparison tool consumers have in credit shopping. Purposely, Reg Z was to preempt the field so that only one, uniform system of disclosure would prevail that consumers could use reliably in comparing one credit source to another. Regrettably, Reg Z enforcement has declined at the federal level considerably.

With new actors and keen competition, there is also great competitive pressure to develop and push new products. In some companies there is clearly inadequate training of new staff and/or inadequate supervision of that staff, such that significant disclosure violations are proliferating. One administrator reported that a mortgage company made literally hundreds of loans in which the only finance charge listed was the prepaid finance charge!

Mortgage Servicing

We have seen the most problems in this area probably because unlike the disclosure area consumers can realize when someone has screwed up and they now have a tax lien on their property or their homeowners insurance has been cancelled. We have received innumerable complaints about these kinds of experiences. Problems have arisen because mortgages have been repeatedly sold and the new servicer doesn't realize when tax or insurance payments are due. More often, however, problems have arisen

because the servicer is disorganized. We have also witnessed property insurance being cancelled and countless cases of surly or unresponsive treatment when calls or letter have been initiated to try to resolve these problems the consumer had no hand in creating.

We have also witnessed unexplained increases in mandated escrow balances due to dubious and self-serving "escrow analyses" performed by the mortgage servicer. People have been required to pay more into escrow for tax and insurance increases that have not occurred. It's great for the servicer who pays no interest (in 38 out of 50 states, at least) on this huge sum of money. The consumer is virtually powerless to do anything about this as he (generally unwittingly) signed the mortgage which contracted for the lender's right to collect anticipated tax and insurance funds.

One way to curb abusive escrow build-ups is to require interest to be paid on such funds as is the case in 12 states,

Fees and Charges

With the growth of the sale of mortgages in the secondary market has come the proliferation of fees and charges, some of them of a dubious nature. We recognize that the secondary market is a valuable development for consumers generally in that it makes more mortgage money available. It also, necessarily,

raises costs to the consumer because more middlemen are now involved, each taking his cut along the way. I think the imposition of these extra charges is now worthy of scrutiny, however, at the national level, to evaluate how necessary and bona fide they are.

Federal Regulatory Preemption

While Garn - St. Germain is history now and most states, by default, have lost the right to assert their own regulatory prerogative in mortgage lending as the three-year override opportunity has almost expired, an effort should at least be made to see adequate federal enforcement in the area they have preempted. Ideally, the preemptive scheme should be modified to give the states some meaningful role in the formulation and enforcement of substantive regulation of first lien mortgage activity.

Consumer Protection Issues

The last item I wish to address is the use of the Rule of 78's. This method of calculating charges has been identified by state administrators as the largest source of complaints. The rule has a number of objectionable features. For one thing, it's difficult to understand, even for lenders. For another, its usefulness is outdated in this age of computers. The rule was acceptable for the short term loans during the 1930's, but it

badly distorts the amount of interest due on prepayment of today's longer-term loans.

More important the borrower always comes out on the short end of the rule of 78's, usually without realizing it. The rule's hidden penalty has been the focal point of criticism by consumer activists, state administrators and even some lenders have admitted it's unfair. Some states such as Idaho, California, Oregon, Arizona and Vermont have repealed the Rule of 78's and NACCA has made the universal repeal of this method its primary issue of reform for 1985-86.

It is one of the stated purposes of the National Association of Consumer Credit Administrators to increase the usefulness and efficiency of the state departments having supervision over Consumer Credit Agencies and promote the general welfare of the consumer and the consumer finance industry cooperating with other organizations whether public or private, to secure uniformity of supervisory procedures and of the laws administered by the agencies in the various states.

Thank you for the opportunity to present our views before this distinguished committee.

The CHAIRMAN. Thank you, Mr. Sutton.

You mentioned in your testimony the enforcement of regulation Z had declined rather dramatically. What's your opinion of why that has taken place?

Mr. SUTTON. I don't think the Federal Trade Commission or the regulatory agencies have enough manpower to properly see that it's adequately supervised. We see it every day in the finance paper that we regulate in these various States that we regulate. Examiners have stated this each and every day practically. We just don't have enough people to see that it's done and it's not being done.

The CHAIRMAN. Do you think regulation Z is too cumbersome?

Mr. SUTTON. Well, it's a little cumbersome, but it's certainly understandable. I don't think that's probably the problem. I think it's a problem of people in the industry seeing that it's enforced.

The CHAIRMAN. Senator Sasser.

Senator SASSER. No questions, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

Senator GORTON. No questions.

The CHAIRMAN. I failed to mention earlier, I suspect we will have some questions for your response in writing from some of the colleagues who were unable to be here this morning. Thank you very much.

Mr. SUTTON. Thank you.

The CHAIRMAN. Next I'd like to invite to the witness table Mr. Stephen Brobeck and Mr. Henry B. Schechter. Mr. Brobeck is executive director of the Consumer Federation of America and Mr. Schechter is the director of the office of housing and monetary policy of the AFL–CIO.

Gentlemen, we're happy to have both of you before the committee this morning. Mr. Brobeck, would you like to begin?

STATEMENT OF STEPHEN BROBECK, EXECUTIVE DIRECTOR, CONSUMER FEDERATION OF AMERICA

Mr. BROBECK. Thank you very much, Mr. Chairman.

CFA greatly appreciates the opportunity to testify on the need for legislation to protect consumers of financial services. In my written testimony I suggest that these services are being radically transformed by a financial services revolution. I point out that this revolution offers several important benefits to consumers—higher interest on deposits, new products and services, and greater economic efficiencies.

COSTS THAT DEMAND LEGISLATIVE REMEDY

But I also indicate that this revolution has imposed costs as well. I'd like to comment on the two most significant of these costs and explain why I think they demand legislative remedies.

The first is the greater confusion resulting from increased complexity of financial services. This has two aspects, the first being a proliferation of products.

Now, 15 years ago, if you went to a bank and with money to deposit, you had available a passbook savings account. Today, you have CD's, NOW accounts, Super NOW accounts, money market accounts, and IRA's. In addition, products are priced much more

complexly. Increasingly, banks charge or pay variable rates on deposits as well as on loans. Increasingly, they have imposed minimum balance requirements on deposit accounts. And increasingly, they impose fees, and charges on both deposit accounts and on loans.

The result mystifies many consumers. I'd like to illustrate this by using an account that's been growing rapidly in popularity, NOW accounts.

Consumers that shop comparatively for a NOW account have more than a dozen different factors to consider. First, they have to consider the interest rate and its method of compounding and method of computing. For if a low-balance method of computing is employed, it's possible that, even if they are being paid a 5.25-percent rate, they will earn no interest at all if the balance in their account falls to zero in the course of a quarter.

They also have to pay attention to regular service fees, monthly service charges, per check charges, per deposit charges, and, increasingly, charges for using ATM's. Moreover, they have to consider minimum balance requirements—minimum balance requirements not just to avoid fees but also to earn interest. Many banks have two different minimum balance requirements on the same NOW account.

They also have to consider special fees—bounced check fees, stop payment fees, and check purchase fees, and increasingly, fees for purchasing copies of checks on those accounts which are truncated. Finally, they have to consider check hold periods.

There are more than a dozen factors here. Consumers must analyze these factors in terms of their own checking needs and habits. This is so complicated that it would even be difficult to develop a computer model that would provide consumers individualized recommendations.

But there is an additional problem beyond this complexity. This analysis is often impossible because it's increasingly difficult for consumers to get adequate information about accounts from banks and thrifts. In survey after survey, Consumer Federation of America, other consumer groups, and the media have shown that information supplied by tellers is often incomplete and, in some cases, even inaccurate. Bank literature is little better. Essentially, this literature is promotional in nature. It is designed to promote the sale of accounts, not provide consumers with the information they need to make wise decisions. In most cases it neglects to disclose the most important costs of these accounts.

GREAT NEED FOR REQUIRED DISCLOSURE

This is why there is a great need for required disclosure on deposit accounts—two types of disclosure. First of all, disclosures of fees, charges, and check hold periods; and second, disclosure of the interest rate method of compounding and method of computing.

The amendment to last year's banking legislation does the first, and we commend the committee and the Senate for approving that amendment, but we would urge the committee to also consider expanding that amendment to include interest rate disclosure—truth in savings—as well.

The second important cost I'd like to address is even more serious. That's the increasing denial of services to low and lower-middle income families. What evidence do we have of this denial? Just several months ago, the Federal Reserve Board released a report on bank fees that revealed a significant increase in families without checking accounts. That data is reported on page 4 of my testimony. Let me summarize it.

It suggests that between 1977–83 the percentage of the lowest 10 percent of all families by income without checking increased from 44 percent to 56 percent, and that the percentage of the poorest 30 percent of all families without checking increased from 37 to 44 percent.

Why is this happening? We think the most important cause is the tremendous escalation of fees, charges, and minimum balance requirements. All periodic surveys that have been conducted by the industry, by the Government, by nonprofit groups and by the media have shown that these fees and charges have increased by 200 to 500 percent over the last several years. The result is, if families cannot meet the minimum balance requirements, they typically pay $100 in fees on a regular checking account and may well, at individual institutions, pay more than $200. This is a sum of money that the members of the committee and those who are testifying today can easily afford, but I would suggest that that is not the case for families that are poor and or near poor. These are families living at the margin. They do not have an additional $100. They have to make the very difficult choice of whether to make their monthly rent payment, or purchase food, or maintain a checking account. The decision in most cases is very simple—they do without a checking account.

What is the alternative for them, because after all, everyone has to make payments in our society? What they do is use convenience stores or check-cashing outlets to cash their checks—checks from their employers or from the Government—and also to write money orders. But we would suggest that this alternative is insufficient for three reasons.

First, it's extremely costly, much more costly than maintaining a checking account in most financial institutions. The typical cost for cashing checks at a check-cashing outlet is 1 to 2 percent of the check. That price goes up in some places to 10 percent. Now for a family that is cashing $10,000—to take the extreme example—of Government checks at a 10-percent fee, that's $1,000 a year.

The second important limitation is that these stores do not offer important banking services. They don't offer safety deposit boxes which poor families need. Since they are more likely to live in high-crime areas, these households are more in need of a place to store their valuables than are other families. Second of all, they don't have available savings options. These are the families that need to maintain a savings account more than any other group in our society. They are people who need a cushion when they get into financial difficulty, and these are the families that increasingly are denied the ability and the incentive to save money.

What is the solution? The last several years the option of requiring banks to offer lifeline or basic checking and savings accounts has been widely discussed. These are accounts which would impose

no or low fees, and have no minimum balance requirements. But I would hasten to add, we are not asking banks and thrifts to subsidize these accounts. We think that they can be offered, and make a profit for institutions, if, for example, banks were allowed to truncate those accounts and also limit transactions. While it's clear that these basic accounts are not going to be as profitable as most other banking services, they should still earn a profit for the institutions.

Moreover, we feel that banks have an obligation to meet the financial needs of all the families in our society because of the many Federal protections that they enjoy.

In conclusion, let me say that profound changes are occurring in financial services. We cannot ignore the problems which have been created which the marketplace is not going to solve. They are not going to go away. They are only going to worsen. And we would urge your committee and the entire Senate to address these problems now rather than later.

Thank you very much.

[The complete prepared statement follows:]

Statement of

Stephen Brobeck
Executive Director

CONSUMER FEDERATION OF AMERICA

CONSUMERS IN THE FINANCIAL SERVICES REVOLUTION

Thank you Mr. Chairman. I am Stephen Brobeck, executive director of the Consumer Federation of America. We appreciate the opportunity to identify emerging consumer problems created by the financial services revolution and to recommend legislative solutions to these problems.

In the space of a few years, technology and deregulation have irretrievably transformed consumer banking services. A decade ago, most banking institutions offered a limited set of highly regulated consumer services within a small service area. Today, these same institutions sell a far more diverse array of products that are priced much more complexly. Moreover, many either already market these services outside traditional geographic and product service areas, or are seeking to do so.

Consumer Benefits

The financial services revolution has already provided consumers with many benefits, and will certainly offer more.

1) The deregulation of interest rates has allowed consumers to earn higher yields on their deposits while continuing to receive federal insurance protection. All consumers able to meet minimum balance requirements are now able to earn interest on checking deposits. They also have the opportunity to earn market, or near-market, yields on their savings in certificates-of-deposits and

money market accounts.

2) This deregulation and the implementation of electronic funds transfer systems has given consumers access to a much wider array of products and related services. In the past several years, banking institutions have introduced NOW accounts, SuperNOW accounts, money market accounts, and variable rate mortgages. In addition, they increasingly allow consumers to have paychecks directly depositted, have access to services round-the-clock, and make transactions outside the institution's service area.

3) Productivity gains resulting from the implementation of new communciations and computer technologies will increase the efficiency and international competitiveness of financial services industries. To the extent these efficiency gains are shared with consumers, they will benefit them directly. Yet even if this savings is not passed on, citizens will gain indirectly as societal wealth accumulates.

Consumer Costs

Unfortunately, the transformation of financial services has also imposed costs on consumers and on society.

1) The most widely publicized costs are threats to the safety and soundness of the banking system. Indiscriminate lending outside their traditional service areas jeopardized the economic viability of numerous banks, most notably Continental Illinois. The deregulation of deposit rates and easing of restrictions on thrift investments allowed imprudent investments that have shaken public confidence

not just in specific savings and loans, but in the entire banking system. Because of the resulting run on deposits, and subsequent government intervention, several million consumers lost access to their deposits.

Of even greater concern are risks often unknowingly assumed by consumers who "invest" their savings outside the banking system--in whole life insurance polcies, money market funds, and other uninsured savings' vehicles. To the extent financial institutions ignore risk in seeking higher yields on the investment of these funds, these uninsured consumer deposits are placed in jeopardy.

2) The inevitable result of the proliferation of products and increasing complexity of their pricing is greater consumer confusion. How many individuals are aware of the more than dozen factors affecting the cost and yield on a NOW account, and the relative importance of these factors to their own account? How many, for that matter, know that money market funds are not federally insured?

Consumer confusion provides opportunities for unscrupulous vendors to mislead or defraud their least sophisticated customers. Lenders charging effective installment loan rates above 50%, and even higher than 100%, are examples of the former, while those promoting fraudulent investment schemes illustrate the latter.

Yet, this confusion also imposes costs on the whole society. The efficiency of markets for financial services requires informed customers who act rationally. Only one of many indications that the financial services revolution continues to mystify many consumers

is that they retain more than $200 billion in low-yielding passbook savings accounts. Among its many implications, this consumer confusion retards the introduction of new, more efficient technologies.

3) Of greatest concern to the Consumer Federation of America is the increasing denial of essential banking services to low and lower middle income families. This loss of services is clearly indicated by data reported recently by the Federal Reserve Board. These data revealed that between 1977 and 1983, as the table below shows, the proportion of the least affluent families without checking accounts increased significantly.

Percentage of Families Without Checking Accounts

	1977	1983
Poorest 10%	44%	56%
Poorest 30%	37	44
Poorest 50%	29	35

In addition, there is some evidence that the proportion of less affluent families without savings accounts is also increasing.

This loss of basic banking services reflects, primarily, the tremendous escalation in bank fees and minimum balance requirements over the past several years; secondarily, bank branch closings and reduced availability of services. All periodic surveys, many of which have been summarized in the Federal Reserve Board's 1985 bank fee report, reveal huge increases in fees and other charges. In its most recent nation-wide fee survey, the Consumer Federation of

American and San Francisco Consumer Action reported that these higher fees hiked the charges on a typical regular checking account to more than $100. At some banks, these charges approach $200. Less affluent families with no discretionary income are forced to choose between these banking services and even more essential products such as food and housing.

Also important appears to be the restriction of banking services in less affluent communities through bank closings, limitations of hours, and substitution of ATMs for tellers. Branch closings have not yet reached epidemic proportions -- only about 500 annually. Yet, as banks increasingly discover that those in poorer neighborhoods are less profitable to serve than are other market segments, this number may escalate dramatically.

Banks point out that those who are unable to use their services have other options -- loans from neighborhood merchants, check cashing and money orders from liquor stores, convenience stores, and check-cashing outlets. The trouble with these options is that they are costly, fail to offer a complete range of important services, and subject consumers to increased risks. Loan rates charged by local retailers are much higher than those charged by banks. Cashing a check typically costs 1-2% of the face value of the check, sometimes as much as 10%. In addition, merchants do not offer savings accounts or safety deposit boxes, two important needs for the poor living in high-crime areas. Finally, relying more heavily on cash than on other forms of payment increases the risk of theft.

At the same time, the poor are not able to take advantage of the rising yields on deposits and are hit hard by escalating loan rates. The 39% of all families who the Federal Reserve Board reports had financial assets under $1000 in 1983, derive no benefit at all from the deregulation of deposit rates. On the other hand, these families, who typically owe about $3000 in non-mortgage consumer debt, have seen their interest payments increase beyond normal levels. When banks created new deposits accounts with higher yields, one of the ways they covered these increased costs was to hike rates on consumer loans.

Legislative Solutions

1) To ensure safety and soundness for consumers, the Consumer Federation of America recommends that Congress:

a) Require all banks and thrifts to participate in federal insurance programs. As recent experience has shown, even financially sound institutions with private insurance are not immune to runs on deposits.

b) Require federal regulatory agencies to publish ratings of the soundness of banks and thrifts. Such public disclosure not only will assist consumers in comparing institutions, but also will serve as a strong incentive for banking institutions to increase capital ratios and improve the quality of their investments.

c) As a condition of product deregulation, require strict prohibitions on "upstreaming" money from financial institu-

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tions to parent or sister companies, strict structural barriers to ensure that financial institutions are separately capitalized and operated from other lines of business, strict requirements for arms-length relationships between financial institutions and parent or sister companies, prohibitions on entering businesses which would endanger the safety and soundness of financial institutions, and authority for federal regulators to protect the safety and soundness of such institutions when a parent or sister company's financial situation may adversely affect an institution. These regulations would help ensure depositor confidence as well as safeguarding the integrity of banking subsidiaries.

2) To reduce consumer confusion and prevent deception and fraud, CFA recommends that Congress:

a) Require clear and comprehensive disclosure of all important terms and conditions of deposit accounts. These terms would include not only methods of computing and compounding yields, but also conditions limiting interest paid. They would also include all fees, charges, and check hold policies. Such a disclosure should be available to prospective customers and should be made to those opening accounts. Any changes in these terms and conditions should be promptly disclosed.

b) When disclosure is not sufficient, regulate specific terms of deposits and loans. While the disclosure of check

holds, for example, may force banks to clear depositted checks more quickly, experience in New York and other states has demonstrated that banks can comply with severe limits on hold periods at minimal cost. In addition, Congress should limit increases in adjustable rate mortgages. At an initial 10% interest rate, a 5% percentage point increase can hike monthly mortgage payments by nearly 50%. Mortgage lenders should be limited as to the frequency with wich they increase rates and the size of such increases.

3) To ensure the availability of essential financial services to all consumers, CFA recommends that Congress:

a) Require federally protected banks and thrifts to offer "lifeline" or basic checking and savings accounts. These accounts would not require minimum balance requirements or fees, in the case of checking would not pay interest, could restrict the number of free transactions, and could incorporate other cost-cutting restrictions. CFA does not expect banking institutions to subsidize these accounts, yet does recognize that they will not earn as high a return as many other products. We believe this a small price for banks to pay for the benefits of federal deposit protection and other federal services.

b) Extend the Home Mortgage Disclosure Act (HMDA) permanently. This statute, which expires this October, requires banking institutions to disclose information about

community lending patterns, which helps ensure that institutions lend a significant fraction of deposits generated from communities back to these communities.

In opinion polls, media interviews, and communications with consumer groups, consumers have expressed feelings ranging from irritation to strong opposition to escalating bank fees and other emerging banking problems. We urge Congress to respond to these concerns by acting on our recommendations, which are supported by other consumer organizations as well. These do not impose onerous burdens on banks and thrifts yet do increase the system's safety and soundness, and guarantee the availability of essential banking services.

The CHAIRMAN. Thank you, Mr. Brobeck.
Mr. Schechter.

STATEMENT OF HENRY B. SCHECHTER, DIRECTOR, OFFICE OF HOUSING AND MONETARY POLICY, AFL-CIO

Mr. SCHECHTER. Mr. Chairman and members of the committee, I appreciate the opportunity to present before you the views of the AFL-CIO on the changing national structure of financial services. I would just cover the highlights in my oral presentation.

In the past 15 months the record of financial experience has been extended in significant aspects.

BANK FAILURES

The Federal Deposit Insurance Corporation's problem list has about 950 banks at the present time. There were 828 banks on the list at the end of last year and 217 in 1980.

It recently became known that 856 thrift institutions, with assets last year of $350 billion, had net worth less than the 3-percent minimum standard set by the Federal Home Loan Bank Board, compared with 653 institutions in 1981.

Also, 43 commercial and mutual savings banks have closed because of financial difficulties so far this year. A post-World War II record of 79 banks failed in 1984. At the current rate, more than 100 banks would fail in 1985.

There has been an increasing tendency for affluent households to bypass the intermediary depository institutions and invest their own funds in market credit instruments. On the other hand, the banking needs of those at the lower end of the income scale may be priced out of reach. If banks would provide these services at affordable prices for lower income deositors it would result in the usual benefits.

There has been a sizable growth of pension funds and money market funds which handle vast amounts of investment funds, as opposed to depository institutions, which has resulted in fierce com-

petition to obtain deposits of household funds and they have paid competitive interest rates to attract funds.

A historically repeated relationship has come into play in recent years, and that is reflected in the bank failures of banks. The competitive escalation of interest rates paid on funds has led to a lowering of credit standards in order to place the funds in investments that would recoup the cost of money plus a profit margin.

The Penn Square Bank failure and the related necessary Federal rescue of Continental Bank were related to high-risk loans that couldn't be repaid. That rescue, however necessary, was a precedent of 100-percent insurance for depositors of over $100,000. It signaled to large depositors that they need not be concerned about the operations and soundness of a big bank and indicated to big banks that they could take high risks and be bailed out. A legislative change to noticeably cancel such an absolute safety net is necessary.

The recent Ohio and Maryland savings and loan crisis were related to unsound lending. Many institutions, anxious to add high-yielding assets to their portfolios, have relaxed underwriting standards on home mortgages and other loans, trading credit risk for interest rate risk in a volatile and uncertain economic environment.

Some of the largest U.S. banks are heavily enmeshed with loans to Third World countries which are not able to meet required debt service repayment. The debtor countries go through one negotiation after another with the International Monetary Fund to establish IMF-approved economic adjustment programs which often cannot be carried out. There is a need for a review of IMF economic adjustment program policies—in which the United States has a heavy stake and a heavy burden—to arrive at policies that could be more favorably effective for the debtor and creditor countries.

A greatly overvalued dollar is, to a large extent, responsible for the negative U.S. trade balance, but there is no effective institution to deal with the great misalignment of exchange rates that gives rise to the negative trade balance which slows down the U.S. economy. The international world economy needs an institution that can effectively coordinate domestic monetary policies to bring about an equilibrium of exchange rates that could avoid the great trade imbalance which threatens to bring on United States and worldwide recessions. A U.S. initiative in this area would go a long way toward establishing the necessary machinery and getting negotiations underway.

The nonbank banking question has been rendered moot by a recent decision of the U.S. Court of Appeals of the 11th Circuit which ruled that the establishment of nonbank banks is illegal. We urge that any attempt to grandfather some of the nonbank banks that were established without appropriate authority should be rejected.

There has been growing discussion of allowing interstate banking on a regional basis and yesterday's Supreme Court decision apparently established that. But that approach or also one with a trigger to go to national interstate banking would lead to an intensification of the competition for deposits which has prevailed over the past several years and which drives lenders into high-risk, unsound loans.

When the shakeouts of institutions will have taken place, as this competition continues, there is likely to be a concentration of financial deposits under the control of a relatively few institutions, either within a region or eventually within the country if the interstate banking goes national. It would then be easier for the larger banks to dominate certain sectors of the credit market. Even under present circumstances, while interest rates generally have been declining in recent months, there has been a noticeable lack of market response on interest rates for certain types of consumer credit.

DANGER SIGNALS FROM EXPANDED INVESTMENTS

Another bit of recent history lights up a danger signal with regard to expanded investment and activity powers for affiliates of banks. Securities underwriters and dealers have played a strategic role in assisting the aggressors in takeover mergers, including bank credit arrangements for leveraged buyouts, the issuance of junk bonds, et cetera. How much easier it would be to finance a takeover attempt if the securities house advising the raider advised him informally about the availability of financing at its bank affiliate. There should not be expanded powers for affiliates of depository institutions.

The last item I wish to comment upon is the competition between money market funds and money market deposit accounts at depository institutions and the proposal that the latter should be receiver interest payments from the Federal Reserve Board on reserves that they have to keep against money market deposit accounts. The depository institutions can offer Federal deposit insurance which the money market funds cannot offer. The history of increases in money market funds and money market deposit accounts, shown in table 2, makes it quite evident that the depository institutions enjoy a tremendous advantage as far as depositors are concerned and where they put their money. The institutions with money market deposit accounts do not need the interest payments on reserves to achieve competitive equity. Such payments would reduce the Federal Reserve Board payments to the U.S. Treasury and the Federal deficit would be increased by equal amounts.

[The complete prepared statement follows:]

85-23

Testimony of Henry B. Schechter, Director
Office of Housing and Monetary Policy
American Federation of Labor and Congress of Industrial Organizations
on Changes in the Financial Services Industry
Before the Committee on Banking, Housing, and Urban Affairs
U.S. Senate

June 11, 1985

I appreciate the opportunity to present before you the views of the AFL-CIO on the changing national structure of financial services and the concerns it raises with respect to prospective legislation in the field. In the 15 months since I last testified before you on this subject, the record of financial experience has been extended in significant aspects.

The number of financial institutions which are in trouble or failed has skyrocketed in recent years. Due to adverse economic conditions, the changing institutional framework in which banks and thrifts operate and losses resulting from loan policies, the Federal Deposit Insurance Corporation's "problem bank" list of banks whose finances merited regulators' extra attention, has about 950 banks at the present time. There were 828 banks on the list at the end of last year and 217 in 1980, according to the FDIC.

It recently became known that 856 thrift institutions, with assets last year of $350 billion, had net worth less than the 3 percent minimum standard set by the Federal Home Loan Bank Board, compared with 653 institutions with $126.7 billion in assets in 1981, using generally accepted accounting principles. Together the thrifts with negative net worth or net worth under 3 percent, totaled almost 40 percent of all institutions regulated and supervised by the bank board and insured by the FSLIC. About 400 of the 856 thrift institutions reportedly have zero or near

zero net worth and are not expected to survive as individual institutions. That would be in addition to the 800 that were merged or shut down by the Federal Home Loan Bank Bank Board over the last 5 years. Richard Pratt, former FHLBB Chairman is quoted as saying that "a third of the industry will just not survive."

In the recessionary period of the 1970's, there were a number of bank failures (14 and 17 in 1975 and 1976, respectively). In the 1980's, however, the number of failures has risen sharply, as can be seen in the table on bank closings.

Forty-three commercial and mutual savings banks have closed because of financial difficulties so far this year, including seven on a single day recently. In the post World War II period, a record 79 banks failed in 1984. At the current rate, more than 100 banks would fail in 1985.

The worsening experience record of financial institutions is related to broader economic trends. With a long-term rise in affluence and economic literacy for millions of American households, there has been an increasing tendency for such households to bypass the intermediary depository institutions and invest their own funds in market credit instruments. Household holdings of such credit market instruments grew from $150 billion in 1960 to $738 billion at the end of 1983, with the three largest types of holdings being Treasury securities, mortgages, and tax-exempt securities.* There has also been a sizeable growth of pension funds and 'money market funds' which handle vast amounts of investment funds, as opposed to depository intermediary institutions.

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*The data are from the Federal Reserve Board "Flow of funds" series for the sector of Households, Personal Trusts and Nonprofit Organizations which represents households, except for a small percentage of the total.

Table 1

Banks Closed Because of Financial Difficulties, 1945-1985 (Commercial and Mutual Savings Banks)

1945-49	Annual Average	4
1950-59	Annual Average	5
1960-69	Annual Average	6
1970-79	Annual Average	8
1970		8
1971		6
1972		3
1973		6
1974		4
1975		14
1976		17
1977		6
1978		7
1979		10
1980		10
1981		14
1982		42
1983		48
1984		79
1985 through June 3		43

Source: Federal Deposit Insurance Corporation.
389-4221

Consequently, the depository institutions have been in fierce competition to obtain deposits of household funds. They have used their authority to pay competitive interest rates to attract or hold funds insofar as possible. They have invested the funds in loans made to finance traditional activities plus activities authorized in recent years, and at loan terms which were relaxed under statutory authority amendments over the years. In the last few years, a historically repeated relationship came into play: competitive escalation of interest rates paid to depositors led to a lowering of credit standards in order to place the funds in investments that would recoup the cost of money plus a profit margin.

The relaxation of credit standards and their effects are illustrated by the experience of the Federal National Mortgage Association, as described in a recent report by the General Accounting Office: "The Federal National Mortgage Association conventional foreclosure loss in 1984 was $87.3 million, up from $38.4 million in 1983 and $1.6 million in 1982." The GAO report cites causal factors such as a decline in rate of house price inflation, high interest rates, and increased unemployment, but also notes the following changes made by FNMA in its mortgage loan purchasing practices: it no longer required appraisals by FNMA-approved appraisers; it relied on lender controls rather than approving each loan individually; it purchased loans on properties overvalued because of "buydowns"; and it changed underwriting standards to allow borrowers to acquire increased debt as a percent of income.

FNMA is, of course, not the only example. The Bank of America announced that its first-quarter 1985 operating results would be near the break-even point, possibly showing a loss, because of continuing rising loan losses in the fields of commercial real estate and agriculture and among foreign borrowers. Last year the bank had made loans to an issuer of mortgage-backed securities that engaged in fraud.

Bad agricultural, mortgage, and oil industry loans have affected many institutions due to the erosion of the value of the security behind the loans. The Penn Square Bank failure and the related necessary Federal rescue of Continental Bank were related to high risk loans that couldn't be repaid. That rescue, however necessary, was a precedent of 100 percent insurance for depositors of over $100,000. It signalled to large depositors that they need not be concerned about the operations and soundness of a big bank and indicated to big banks that they could take high risks and be bailed out. A legislative change to noticeably cancel such an absolute safety net is necessary.

Rising interest rates have reduced net income of fixed rate assets at institutions. Risky loans by thrifts in areas outside their traditional areas have caused losses, exacerbated by interest rate competition between institutions which have recently been deregulated. The recent Ohio and Maryland S&L crisis were related to such lending. The savings and loans were paying competitively high rates and made loans that promised high returns but were unsound. A lack of Federal insurance also left a low confidence potential. Many institutions, anxious to add high yielding assets to their portfolios, have relaxed underwriting standards on home mortgages, thus trading credit risk for interest rate risk in a volatile and uncertain economic environment.

Many of the largest U.S. banks are heavily enmeshed with loans in third world countries which are not able to meet required debt service payments. The debtor countries go through one negotiation after another with the International Monetary Fund to establish IMF-approved economic adjustment programs which often cannot be carried out. Furthermore, the programs often call for restrictions upon imports, which keep out U.S. production. There is a need for a review of IMF economic adjustment program policies -- in which the U.S. has a heavy stake -- to

arrive at policies that could be more favorably effective for the debtor and creditor countries.

Many weaknesses of financial institutions are, in part, related to a rising number of business bankruptcies in recent weeks, which stems from a slowdown in the pace of economic growth in the United States. An important factor in the economic slowdown is negative trade balance. Last year the excess of imports over exports was $123 billion. In the first four months of this year, the negative trade balance was 6 percent greater than in the comparable period of 1984.

It is generally acknowledged that a greatly overvalued dollar is, to a large extent, responsible for the negative trade balance; but there is no effective institution to deal with the great misalignment of exchange rates that gives rise to the negative trade balance which slows down the U.S. economy to such an extent that major sectors of the U.S. economy, including financial institutions, must suffer from the overall slowdown and increased failures in domestic business. Also, because of the slowed growth of the U.S. economy, countries that export to the U.S. must soon feel the rebound effects and their economies also slow down, aggravating the international debt problem. The international world economy needs an institution that can effectively coordinate domestic monetary policies to bring about an equilibrium of exchange rates that, with agreed upon adjustments from time to time, could avoid the great trade imbalance which threatens to bring on U.S. and worldwide recessions. A U.S. initiative in this area would go a long way toward establishing the necessary machinery and getting negotiations under way.

To enhance the competition for household funds among depository intermediaries through nonbank-bank legislative loopholes, or through legislation that would accelerate the drift toward interstate banking, would invite stronger

support for higher interest rates than would otherwise prevail and lead to further weakness of the financial structure. It is not inconceivable that a financial crisis involving the equivalent of several Continental Bank cases could result in a necessary Federal control of the financial structure that has not been contemplated, for some undetermined period.

The AFL-CIO has consistently opposed the continued exploitation of the nonbank-bank legislative loophole to establish interstate banking which would permit greater concentration of financial and economic power. The entire question has been rendered moot by a recent decision of the U.S. Court of Appeals of the 11th Circuit which ruled that the establishment of nonbank-banks is illegal. We urge that any attempt to grandfather some of the nonbank-banks that were established without appropriate authority should be rejected.

With the court decision prohibiting nonbank-banks, it will not be easy for nonbank organizations to enter the banking business and engage in interstate banking and in various activities in which banks are now permitted to engage. To the extent that they still can and do -- through acquisition of depository institutions and other financial service enterprises -- enter into various financial activities, consideration might be given to making them subject to provisions of appropriate Federal laws.

There has been growing discussion of allowing interstate banking on a regional basis. Some such proposals are also combined with the idea of a trigger to permit nationwide interstate banking after a few years. Either approach would lead to an intensification over the next several years of the competition for deposits which has prevailed over the past several years, and which drives lenders into high-risk, unsound loans. It leads to more business failures, a drag in the economy, and a weakened financial structure.

If and when the shakeouts of institutions will have taken place, there is likely to be a concentration of financial deposits under the control of a relatively few institutions. It would be the sort of structure that would lend itself to an oligarchical division of geographic markets, through a mutual meeting of minds that arises under such circumstances without the necessity for a spoken or written agreement. Even with some restrictions against undue concentrations of power, there probably would develop much greater concentrations of deposits in many market areas than presently exists. Under those conditions, it would be easier for the larger banks to dominate certain sectors of the credit market, such as in consumer financing. Even under present circumstances, while interest rates generally have been declining in recent months, there has been a noticeable lack of market response on interest rates for certain types of consumer credit.

A number of legislative proposals would permit states to set the rules for interstate banking, based on location of states whose banks might be allowed into the state, or based on reciprocal treatment by another state as to entry of out-of-state banks. It would be an abdication of Federal responsibility for a sound competitive financial system to allow states to design rules for large regional banking conglomerates which could exercise their power to their own advantage within a region, while developing modes of operation that could be noncompetitive with similar conglomerates in other regions.

Another bit of recent history lights up a danger signal with regard to expanded investment and activity powers for affiliates of banks, in some cases where the bank and affiliates would be under the same bank holding company. Securities underwriters and dealers have played a strategic role in assisting the aggressors in takeover mergers. They have helped raiders in the planning and execution of takeover plans, including the bank credit arrangements for leveraged

buyouts, the issuance of junk bonds, and other financial devices to execute such takeover attempts. Many of these attempts may either result in the payment of "greenmail" which leaves the intended victim independent but financially debilitated. A successfully merged company may also be in a weakened position as assets are sold off to repay some of the debts accumulated in the takeover fight. Imagine how much easier it would be to finance a takeover attempt if the securities house advising the raider advised him informally about the availability of financing at its bank affiliate.

To avoid additional support for activities of questionable value and potential conflict of interest, there should not be expanded power for affiliates of depository institutions, including the underwriting of all obligations issued or guaranteed on behalf of state or local governments or agencies thereof; the underwriting and sale of investment company securities; organization, control, and operation of an investment company; and dealing in and underwriting mortgage-backed securities rated in one of the four highest rating categories -- including two categories indicating relatively high risk. Such dealings by affiliates of depository institutions would again invite the sort of dangers which led to the Glass-Steagall Act in the thirties.

The last item I want to comment upon is the competition between money market funds and Money Market Deposit Accounts at depository institutions and the proposal that the latter should receive interest payments from the Federal Reserve Board on reserves that they have to keep against MMDAs. The money market funds do not have to set aside such non-earning reserves and presumably are in a better competitive position than depository institutions to pay higher interest rates in order to attract household savings for investment. However, the depository institutions can offer Federal deposit insurance which the money market

funds cannot offer. The history of increases and decreases in money market funds and Money Market Deposit Accounts since the latter were authorized, shown in Table 2, makes it quite evident that the depository institutions enjoy a tremendous advantage as far as most depositors are concerned. The Federally insured depository institutions, starting from zero in November 1982, have had a continuous growth of Money Market Deposit Accounts, reaching an aggregate total of $433 billion by the end of January 1985. Over the same period, the aggregate total held in money market funds declined and then rose to $215 billion, about where it had been before. The depository institutions do not need the interest payments on reserves to achieve competitive equity. The payment of net earnings made annually by the Federal Reserve Board to the U.S. Treasury would have to be reduced by an equal amount, and the federal deficit would, of course, be increased by such an amount.

Table 2

GROWTH OF MONEY MARKET FUNDS AND MONEY MARKET DEPOSIT ACCOUNTS

	Money Market Funds Total Net Assets (in millions)	Money Market Deposit Accounts (millions of dollars)
January '85	$214,506	$433,800
December '84	209,732	415,100
September '84	182,760	383,400
June '84	177,630	392,900
March '84	173,777	392,500
December '83	162,595	375,900
September '83	163,006	366,900
June '83	164,631	367,300
March '83	180,311	320,500
December '82	206,608	42,900

Sources: Investment Company Institute, Federal Reserve Bulletin (Table 1.21).

The CHAIRMAN. Thank you, Mr. Schechter.

Mr. Brobeck, you cite the problem of the difficulty of low-income families obtaining essential banking services and cite the Federal Reserve study for that. I am also familiar with the study that's been done by the ABA that indicates that that is a factor but not the only factor in people making those choices.

Are you familiar with that study and do you have any comments?

STUDY ON LOW-INCOME FAMILIES

Mr. BROBECK. I am aware that that study exists. I have not looked it over carefully. As I understand it, there have been problems with that survey. One is that it's very difficult to sample low-income families by telephone. A number of them don't have access to telephones.

Second of all—that questionnaire was designed by the bankers who were attempting to defend charges that fee escalation is the principal cause of families dropping out of the banking system. I would ask the bankers to come up with an alternative explanation. I think it's quite clear, both in terms of our experience and in terms of the evidence, that this is not the only factor but it is the principal factor.

A second factor, by the way, is that these services are being withdrawn from low-income areas and increasingly from rural communities that are served traditionally only by one bank branch. As I point out in my written testimony, the problem with bank branch closings has not yet reached epidemic proportions, but it threatens to as banks increasingly understand that there are many branches operating at a loss or at a relatively low-profit rate.

ATM's are clearly not an alternative because ATM's do not provide the most essential services low-income families need, namely, cashing Government checks and writing money orders. In addition, banks have been curtailing hours at many of their branches.

So I would ask the banking institutions to come up with an alternative explanation for these statistics which are highly significant—to have, in a 6-year period, an increase of 12 percent of low-income families without checking.

The CHAIRMAN. Well, I understand, but on the issue of bank closings, beyond the issue of lifeline services, but the issue of branches, how do you expect institutions to maintain unprofitable branches? Giving lifeline checking accounts doesn't solve that. That's a different problem. And it isn't just ATM's. It's proliferation of services into other areas, the whole problem I've been working on for years of nonbank banks and so on that are causing those institutions to close these branches.

What alternative do you have for that, if you've got a branch that, no matter what kind of services you have within that branch, it's losing money?

Mr. BROBECK. I'm sure you noticed in our testimony we are not recommending that Congress pass legislation to prohibit closing of bank branches. In addition, I hope you appreciate the fact that we are not asking banks to operate services at a loss.

We believe, however, that many of those branches that banks would like to close could be made profitable if, for example, accounts were restructured through truncation or reporting requirements on passbook savings accounts were limited to every quarter rather than every month. That's the principal cost of a savings account to a bank.

We also are willing to accept some curtailment of teller services, reduction in number of tellers. We believe that in most cases, by taking these economy measures, bank branches can be profitable.

What we are concerned about, Mr. Chairman, is that banks, without making that effort to make their branches more efficient, will take inadequate data and use that as the basis, because it shows that that branch is only earning 4-percent profit rate rather than a 9-percent profit rate, to decide to shut it down. If this were another industry, we would not be suggesting that the Government require banks to offer these lifeline services. But banks and thrifts enjoy extraordinary protections from the Federal Government.

The CHAIRMAN. I'm a little bit puzzled by the 12-percent rise because you made the point very strongly in your own testimony how much more expensive the liquor store check cashing was, the money orders and all of that. So even though check charges have increased rather dramatically in certain institutions, why are people leaving them for services that are still much more expensive? You see my point? You made that point yourself. There used to be a bigger gap, but there's still a gap. They are still more expensive. So I'm puzzled by why they are leaving something that has gone up in cost but going to something that is more expensive still.

Mr. BROBECK. Well, on average, I said the typical charge for cashing a check is 1 to 2 percent of face value. That is relatively equal to the cost, at a typical branch, of maintaining a regular checking account.

I think that another reason is that banks, through all kinds of signals that they are sending to their low-income depositors—it's not all banks across the board but it's a growing percentage—are saying that they really don't want those people as customers. That's reflected in many different ways. It could even be reflected in the way tellers treat some of those small depositors.

I think there are some other factors as well and fee escalation is not the only reason. There are some families that don't want to leave a paper trail, and they're afraid if they put their money in a bank there will be a paper trail that will be damaging—to those who participate in the underground economy. And there are other factors as well which we recognize.

The CHAIRMAN. There's another factor, as an example, I certainly am not poor but I don't have big balances with seven kids and two houses and all that. I mean my accounts are small, very small, and I use checking primarily because there are a lot of transactions—50 or 60 checks a month on the average. I've got some of my married kids that have as big an account as I do or would have but they haven't built up the structure after all the years of needing to pay this bill and that bill and all that. So even though they are charged, they don't bother to have checking accounts simply because there may be four or five transactions a month and it isn't

economical and they do use the money wherever they need that month and pay cash.

So all I'm driving at, I don't dispute your figures. That is not my point. I'm just trying to indicate that there are a lot of factors in that change that I'm not sure I understand or that anybody does. I think their costs are obviously a factor and probably you're correct that it's the primary factor, but there are a lot of other reasons. As I've watched the financial services industry change, it isn't just for the lower income. It dramatically changed for everybody in the last 5 or 6 years because of this revolution that is going on out there.

SO-CALLED SAFETY NET FOR BIG BANKS

Mr. Schechter, not a question but a point—you and others often testify about the so-called safety net for the big banks and Continental Illinois is used as the primary example and deservedly so. But the point I'd like to make here, however, is that in looking at the regulatory structure and so on and why you make a decision to do what was done in that case, Continental is a bank that had a very small retail deposit base because it existed in a State that doesn't allow them to branch across county lines. You talk about branches. Continental can't have branches with the archaic laws that Illinois has. Forget the issue of interstate branching. They don't have intercounty branching.

So when you look at some of the reasons why are they out with all these international loans, that's one of them. They didn't have a retail deposit base to fall back on. But nevertheless, when it's constantly cited that we're going to bail out a large one like that, there are some surveys that indicate that the correspondent banks that do have a retail deposit base and a lot of small institutions, that there was a potential for failure of over 100 banks as a result of that.

So I only wanted to indicate, yes, it's easy to say for Continental we're providing a security net for a big bank that made some dumb loans and Continental did that all by themselves and I'm one that would say, well, they goofed and let them die, but the repercussions, just like the Penn Square Bank—it wasn't Penn Square that was such a problem; it was a lot of credit unions, small credit unions. So the repercussions, I'm sure you would agree, are far beyond that one large institution.

Mr. SCHECHTER. And I realize that once Continental was in the situation it was it had to be rescued, but there could be in the law provision made for them to have to absorb a certain amount of the loss that come up on their own rather than have the FDIC——

The CHAIRMAN. They did. The stockholders took more than a $1 billion hit.

Mr. SCHECHTER. That provision would help. But the other thing is, in this entire experience that we have had in the last couple of years, that indicates to me that the examination system is lacking. In other words, many of these things were going on for a while and they weren't really brought to the notice of the top regulators and they didn't do anything about them if they were brought to their notice. So there is a need for a strengthening I think. Otherwise, we let the thing go on as given, especially in the volatile environ-

ment we have, and more and more of these institutions, especially small ones, will be getting into loan situations where there are very high risks and with poor results and we see it in the numbers with the constant increase in failures.

The CHAIRMAN. Well, I don't disagree with you that we need to overhaul the regulatory structure and the deposit insurance structure. I have been hoping we could get to that for some time. It makes some sense to me to make decisions in the form of comprehensive legislation as to who would be doing what before you start trying to decide who's going to regulate what, getting into subjects like regulation by function and risk-related premiums and things of that nature. So I agree with you, Henry, that there needs to be not just a strengthening but I think an overhaul of regulatory and insurance functions and this committee will be getting involved in those areas as well.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Brobeck, you offer the curious and peculiar notion that these days the marketplace is not going to solve the problem of the low-income person with regard to not having a savings account.

What about the concept of these consumer banks, the so-called family banks? How would they impact, in your judgment, on the problem of the lower income people banking and checking accounts?

Mr. BROBECK. If I may make two comments to your question, Mr. Sasser. The first is that in our society you have a conflict between two essential values—the value of economic efficiency and the value of equity. This is a problem that every capitalistic society has had in the history of the world and, to the extent that you increase efficiency, but equity problems will develop, and that is what's happening.

We support deregulation generally because of it's tremendous increases in efficiency, product innovation, productivity, international competitiveness. At the same time, we have to pay attention to these problems of low-income families.

As to whether family banks would represent a desirable and even a sufficient solution to some of the equity problems that have emerged, I think that very clearly, all other factors being equal, that we would welcome the introduction of these family banks offering sympathetic accounts to consumers.

On the other hand, there's no question that retailers like Sears cannot adequately serve the needs of all low-income families in our society. They simply don't have enough branches in the right places. And so we would encourage Congress to ask all institutions to meet the kind of tests that are required of family banks in the legislation that Sears has proposed.

Senator SASSER. So you would ask—as I recall the Sears proposal provides for low-fee checking accounts. Is that accurate?

Mr. BROBECK. I'm not familiar with all the details. It would be low fees and in return we accept limitations on transactions, which is the principal cost of maintaining these accounts.

IMPACT OF FULL INTERSTATE BANKING

Senator SASSER. Mr. Schechter, you expressed your concern about the impact of regional or full interstate banking on concentration of economic power. Now the House Banking Committee is considering a bill that would prohibit the 25 largest banks in terms of deposits from acquiring each other and a bank holding company could not acquire another bank if by so doing it would control more than 2.5 percent of the total U.S. deposits or exceed a percentage of deposits that's set by a particular State.

What about these safeguards? Are they adequate? Would they make you change your mind about interstate banking leading to too great a concentration of economic power?

Mr. SCHECHTER. No, Senator, for these reasons. I believe that same bill provides that even the 25-largest banks can acquire institutions of up to $100 million without any limit. They can pick up one, a second, a third, and so on. So they could acquire a number of additional institutions in different States.

In addition, if you used the 2.5 percent limit—after all, conceptually that means you could have a concentration of any bank that had even the 2.5 percent would have 1/40th of the deposits in the country, and if you had an equal distribution of banks each one having 2.5 percent of the deposits, you would have only 40 banks in the country. We have 14,000 or so now. So I think it makes way for a much greater concentration than we have now.

I'm not saying you're going to get just 40 banks, but if you get a few of them they become very powerful, and this I would be concerned about.

Senator SASSER. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. This morning, we will continue to hear testimony regarding the health and stability of the financial services industry. Before I continue, Mr. Chairman, I would like to commend you on conducting this set of hearings and I also would like to welcome the distinguished panel of witnesses here today. I understand the schedules these gentlemen have and I appreciate their taking the time to join us to testify on this important topic.

The financial services industry in this Nation is showing signs of strain. Recent developments in the thrift industry, with bank failures in Maryland and Ohio, troubles with foreign loans to small developing nations, and disturbances in the Government securities market, are all aspects of this growing strain.

There is a general feeling by those concerned with the industry that something must be done. I believe this set of hearings provides the proper forum for pertinent and relevant information to be heard. It is my hope that this information can be used to help us cure the current problems in the services industry.

Thank you, Mr. Chairman.

The CHAIRMAN. I failed to suggest to the other witnesses, but I'm sure they know—their full statements will be included in the record as if delivered in full.

Senator Dodd.

Senator DODD. Mr. Chairman, I apologize for not being here and missing the statements. I have some questions prepared, Mr. Chairman, and maybe I could just submit them in writing.

The CHAIRMAN. That will be fine and we would be happy to do that. I have some others to be submitted as well.

Gentlemen, thank you very much for coming today. We appreciate your testimony.

The committee is adjourned.

[Whereupon, at 11:35 a.m., the hearing was adjourned.]

[Responses to written questions of committee members follow:]

American Financial Services Association

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Robert B. Evans
President

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August 14, 1985

Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for giving AFSA the opportunity of testifying before the Committee on June 11, 1985 on changes in the financial services industry.

As always, AFSA appreciates your commitment to deregulation and your efforts to reform the financial services system. You have posed the following questions to AFSA:

1. In your testimony, you stated that consumers cannot always obtain the information they need to make an informed choice on where to place their savings. Do you have any suggestions on how to keep a Truth-in-Savings requirement simple and yet have it apply to the variety of savings instruments offered by different segments of the financial services industry?

   Usually it is possible but it may not always be easy for consumers to obtain all the information they need to make easily an informed judgment on savings accounts because of the complex nature of the problem. Yield on accounts can vary because of amounts invested, maturity, and periodic rate as well as because of differences in transaction capability and even regulations. Simple comparisons are not always possible but complex disclosures are not usually very useful except to those inherently interested in the process.

If some sort of Truth and Savings is legislated, requirement for disclosure of a periodic rate should be limited to an annualized percentage rate on a 365 day year which is the one year analogue of the periodic rate for the given maturity. For example, the disclosed rate on a 90 day certificate of deposit should be 365/90 times the ratio of the maturity value to the original value. To make assumptions about compounding or reinvestment rates available at later times of maturity is likely to be misleading. Disclosing a range of possiblities or an array of assumptions is likely to be confusing. The simplest manner is likely to prove best.

2. You mentioned your members' desire for a credit card bank. Does the exemption of a credit card bank in H.R. 20 meet your needs?

   Although many AFSA members are using limited service banks to offer credit card programs, AFSA has not endorsed a limited service bank restricted solely to credit card products. The AFSA consumer bank proposal allows a full range of consumer and real estate secured lending products.

   H.R. 20's credit card bank proposal - while the first recognition by the House Banking Committee of the concept that limited service consumer banks should be exempt from the Bank Holding Company Act - provides too restrictive a framework as it precludes the taking of insured deposits and the offering of all other lending products.

3. In the last 4 years, the prime rate has come down rather substantially - yet the rate charged by credit cards has not decreased at all. Can you explain this? Some are arguing for a national consumer credit card usury ceiling. What is your view?

   The rate charged on credit cards is not strictly associated with the prime rate for a long list of reasons and so it should not be surprising that credit card rates do not fall as rapidly as the prime rate as rates come down. Credit card rates did not rise as rapid in 1979-81 either, a fact almost forgotten today. Without elaboration, some of the reasons for differences between credit card rates and the prime rate are:

1) The prime rate normally is available on large credits where the processing cost is small in relation to the raw material (money) cost, thereby allowing the prime rate to follow closely the raw material cost. Credit cards normally involve small credits where processing costs loom relatively larger. Since processing costs fluctuate more slowly than raw material costs, credit card rates do not follow the raw material cost as closely.

2) Yields on credit cards are generally considerably lower than rates disclosed under Truth in Lending because of the existence of free periods under most card plans.

3) Truth in Lending and other regulations make any changes in consumer credit plans administratively complicated, including even rate reductions.

4) The question why credit card rates have not come down more seems to assume they went up enough in 1979-81. Even at a zero processing cost during these years card plans lost money. Bankers who found out it was very difficult to raise rates probably are not as fast to cut them today.

5) Despite these factors, ancedotal evidence suggests more credit card plans are using floating rates today anyway.

My view on usury ceilings, based on results of 4,500 years of recorded history of interest rate controls, is that they never work to lower rates. Instead, if controls are established at a rate below the supply-demand equilibrium, the result is credit shortage. In sum, if rate ceilings are set high, they do no good; if they are set low they cause shortages, calling into question the wisdom of establishing them. These effects are discussed more fully in AFSA testimony before two subcommittees of the House Banking Committee which I am enclosing.

4. In his testimony on behalf of Reserve City Bankers on June 19, 1985, William S. Edgerly expressed concern with companies which are not regulated as bank holding companies having direct access to the payment system and the Fed wire. They recommend legislation which will prohibit such direct access by companies which are not bank holding companies. What are your views?

Mr. Edgerly's views enacted into legislation would certainly benefit large bank holding companies by tending to support concentration of banking and payments through these institutions. However, I do not think that legislation is needed in this area. Existing legislation, especially Section 23A of the Federal Reserve Act already adequately separates banks from their affiliates. While we at AFSA certainly support Federal Reserve efforts to minimize possible systemic difficulties that could theoretically arise in the wire-payments mechanism, we are not convinced that systematic exclusion of new entrants from any markets well serves the public.

Again our thanks for the opportunity of sharing our views on these important issues.

Very truly yours,

Robert B. Evans
President

Enclosures

Questions of Senator Dodd for John Sutton, Jr., National Association of Consumer Credit Administrators, June 11, 1985

1. In your testimony, you point out that for deregulation to be successful, there must be adequate disclosure. I share your opinion and wonder if you might expand on what the appropriate elements of a truth in savings proposal would look like ?

2. Having purchased a house myself, I share your view that mortgage documents are extremely complicated. Would you recommend that we mandate federally plain language requirements, since it was the Congress that deregulated the first mortgage transaction ?

Answers

1. Appropriate elements of a Truth in Savings proposal would, in my opinion be to have every Savings Institution use plain, simple, understandable language for everyone. That is, show the true percentage rate to be used, and have all institutions use the same rate and terms.

Some institutions are now using a 360 day year while others follow a 365 day calendar. Some use simple interest while others compound daily, or monthly, quarterly, or annually.

It is very hard for the public to know or understand what to expect when Savings Institutions are offering many varied methods for figuring the percentages on customer savings.

2. As to complicated mortgage documents, personally I hate to see anything federally mandated, but again, plain language for all mortgage documents is sorely needed.

Consumer Federation of America

STEPHEN BROBECK'S RESPONSES TO QUESTIONS FROM MEMBERS OF THE SENATE BANKING COMMITTEE

Questions from Senator Garn

1. In your testimony you support requiring banks to offer lifeline banking. Many suggest that the banks which voluntarily offer such accounts have experienced little or no interest on the part of consumers generally. Consequently they have concluded that for a variety of reasons many prefer not to have a checking account. How do you explain the poor responses these accounts have had?

ANSWER: 1. We have seen no evidence to suggest that there is little or no interest in lifeline accounts. At present, only a handful of commercial banks offer checking or passbook savings with a limited number of free transactions, no or modest monthly service fees, and no or low minimum balances. Those that have introduced and marketed such accounts, such as Security Pacific National Bank, have received a positive response. It is true, however, that the traditional "no-frills" checking accounts offered by many banks have limited appeal. These typically assess a modest monthly service fee and relatively high per transaction charges.

QUESTION: 2. Should institutions willing to serve low income families be permitted to fill all the financial needs of the poor - from financial planning, insurance, to tax advice? Wouldn't these services along with check transactions and other cost saving services you mentioned make marginal branches more profitable and provide valuable services to low income communities?

ANSWER: 2. We question whether commercial banks would be interested in offering diversified services to the poor, yet do believe diversification would increase consumer choice and competition in financial service markets generally. As I indicated in my testimony, our principal concerns here are that consumers not be asked to subsidize non-consumer products and that safety and soundness are preserved. To these ends, we support a strict separation between financial institutions and parent or sister companies.

Questions from Senator Dodd

1. In your recommendations to address safety and soundness, you would require federal regulatory agencies to publish ratings on the soundness of banks and thrifts. My fear is that the average consumer would not read those ratings, but they could produce runs on the weaker institutions and thus pose a serious threat to federal deposit insurance. How do you respond to that concern ?

ANSWER: 1. Because of federal deposit insurance protection, runs on institutions with low ratings are even less likely than disinvestment in companies who receive unfavorable ratings from investor services. The major problem here is to design a rating system that adequately measures the safety and soundness of the institution.

QUESTION: 2. You call for product deregulation under certain conditions. What new products would you permit banks to offer?

ANSWER: 2. We would not strenuously object to any types of products as long as there was strict separation between the parent or sister companies offering these products and the financial institution. However, if diversification were to be restricted, it would seem most appropriate to limit new products to such financial services as insurance and brokerage.

QUESTION 3. Could you describe some of the "lifeline" banking approaches being taken in the marketplace by such institutions as the Bank of America and tell us how you think they're working ?

ANSWER: 3. Only a handful of banks have introduced legitimate "lifeline" accounts with a limited number of free transactions, low or modest monthly service fees, and no or low minimum balances. To our knowledge, Bank of America is not among them. Security Pacific National Bank, however, has introduced discount checking with up to ten free transactions, a $100 minimum balance, and no monthly service or per check charges. Security Pacific sees this account, according to the American Banker, as "profitable in its own right and capable of increasing the bank's ability to cross-sell other banking services."

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July 11, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

In response to your letter of July 1, 1985, I am submitting for the record of the June 11, 1985 hearing before your Committee, on changes in the financial services industry, the following answer to a written question from Senator Dodd.

Senator Dodd's Question:

In your testimony, you talk about the need to close the nonbank bank loophole. Do you also favor closing the South Dakota loophole?

Reply to Senator Dodd's Question:

Yes, I am in favor of closing the South Dakota loophole, under which the State of South Dakota issues state charters for banks, which are permitted under those state charters to perform activities in other states, such as insurance underwriting. It would be desirable to enact a preemption of state laws that permit bank subsidiaries to engage in activities prohibited under the Bank Holding Company Act. It is an illogical extension of state powers to authorize a state-chartered institution to conduct financial operations in another state which wishes to preclude such operations by institutions that are chartered by other states. A federal preemption statute could prohibit banks from engaging in activities outside of their home state which are not authorized by the Bank Holding Company Act. There could be a similar prohibition on state-chartered thrifts to force them to conform to federal law. States then could authorize additional powers to their institutions only if they conform to powers authorized under the Bank Holding Company Act or are powers limited to in-state activities directed at residents of that state.

Another aspect of permitting banks to engage in insurance activities would be a subtle reduction of competition in the offering and sale of certain types of insurance, which would impact adversely upon consumers in general and upon one group of workers in particular.

For applicants seeking a loan at a bank that was marketing insurance of an affiliated company, as a minimum, there would be a perception that the purchase of insurance at the bank, especially if credit life insurance is required, would enhance their chances of getting a loan. In addition, the availability of insurance from the loan officer or someone else in his office, as well as subtle, oral pressures that might be exerted by loan officers of banks and savings and loan associations, would give their insurance affiliates an unfair advantage over competitors. Some 15,000 agents of insurance companies who are members of the United Food and Commercial Workers Union, an affiliate of the AFL-CIO, would be adversely affected. Expansion of banks into the insurance field would further the concentration of economic power and reduce the bargaining power of consumers. The AFL-CIO strongly favors the previously proposed objective of the restriction upon tandem operations by banks. In addition, in light of the bank environment and opportunities for subtle pressures to be exerted upon prospective borrowers, there should be a complete prohibition upon banking marketing of insurance products by an affiliated company.

Sincerely,

Henry B. Schechter, Director
Office of Housing and Monetary Policy

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COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

PART II

THURSDAY, JUNE 13, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Gramm, Proxmire, Riegle, Sarbanes, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Our witness has not yet appeared, but the new Secretary of the Treasury will learn that the Senate Banking Committee starts exactly on time, whether the witnesses are here or not. So we have started, keeping the record intact, a record that I wish I had never started, but I am as locked in to starting this committee on time as Senator Proxmire is locked in to having a 100-percent voting record for the last 50 years. [Laughter.]

Senator PROXMIRE. Nineteen.

The CHAIRMAN. Only 19.

Well, we both have our prisons that we have locked ourselves into, but the committee has once again started on time, and we will now recess until our witness arrives. [Laughter.]

[Recess.]

The CHAIRMAN. Mr. Secretary, we're happy to have you with us today.

I was just explaining before you came in, the committee meeting had already started, because I made the mistake 4½ years ago when I became chairman of this committee, stating that it would always start on time. I have locked myself in that prison where it starts exactly on time whether anybody is here or not. I was explaining that Senator Proxmire has made a similar mistake, and even worse, he has had a 100-percent voting record on the floor for 19 years. We both have our little prisons that we have constructed.

We are happy to have you before us, the first time as Secretary of the Treasury.

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Over the last 4 years the Treasury has been a very, very active participant in our efforts to promote competition within the financial services industry, consistent with our role of almost maintaining safety and soundness. I notice your written testimony mentions anticipating a close relationship with this committee, and I must say that I certainly appreciate that statement, especially in light of all of the other responsibilities that you have at Treasury. I certainly look forward to working with you and your staff in trying to resolve some of the difficult issues that we face in the industry.

Senator Proxmire, do you have any comments?

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. I just have one comment, and this is a very sad day, in my view, for the banking system in our country. I understand the House has put a trigger in their bill to go to interstate banking, and Mr. Secretary of the Treasury, who we all esteem and admire, has recommended on page 5 of his statement, that we proceed to the trigger.

The New York Times had an editorial this morning calling for it, and I think that's most unfortunate. This country is unique; it's the only country on the face of the Earth that has diversified banking. We have 14,000 separate, individually owned banking institutions. Other countries have five or six banks that do 95 percent of their business. They have a concentration of financial power; we don't.

I think that uniqueness has served us well. We have the best capital markets in the world. At the same time, we have local banks owned locally by local people, and I hope that we can have a real battle on this. It looks as if the odds are stacked against those of us who believe in retaining what has served this country so brilliantly for so many years. So I'm anxious to hear the Secretary of the Treasury on this matter, because I think it is critically important.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. I think Senator Mattingly was here before me.

Senator MATTINGLY. Thank you, Mr. Chairman.

The CHAIRMAN. That's true, Senator Heinz, and I wasn't paying attention this morning, so I thank you for your courtesy in letting Senator Mattingly go first.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Amazing, this much courtesy so early in the morning.

Before we get to you, I'd like to comment on what Senator Proxmire said. I would like to call the committee's attention to a landmark Supreme Court decision handed down earilier this week. The Supreme Court on a 8 to 0 vote has upheld the legality of a State-enacted regional banking statute under the Constitution and the Bank Holding Act. The Court's opinion is definitive, and leaves no open questions on this subject. Its meaning is crystal clear; no changes needed in present law in order for the States to participate in regional banking or in other interstate banking arrangements.

As this committee is well aware, title IX in the bill passed by the Senate last September, S. 2851, had the purpose of clearing away the legal clouds produced by the regional banking litigation that led to this Court decision. The bill that I introduced earlier in this session, S. 716, also had that exact purpose.

That litigation was instigated by Citicorp which wants nationwide interstate banking right away by Federal fiat. Citicorp has lost in this litigation decisively, but they do not appear ready to stop their campaign. Citicorp's field marshal in this effort, Hans Angermeuller, was quoted after the Court's decision as saying, "I can't tell you what our strategy is—but I'm sure that somehow we can slow down the regional mergers."

As evidenced in it's votes last fall, the Senate overwhelmingly supports a policy of letting the States determine the nature and extent of interstate banking. That policy is embodied in the present law. The Supreme Court has made that plain in the present context. The Court has cleared the way for the regional banking process to continue. Therefore, Mr. Chairman, I don't think we need title IX or any other provisions dealing with the geographic expansion in any banking bill which this committee will forward to the Senate.

The CHAIRMAN. I would say to the Senator from Georgia that I appreciate your bringing up the case before the committee. Last year, as you pointed out, we passed on an 89 to 5 vote, a bill that included the title that essentially made the same decision that the Supreme Court did this week, and I certainly see no need to have an interstate banking title in our bill this year at all.

The Supreme Court made the same decision we did. We survived two filibusters, one with something like 91 to 3. The cloture was invoked. I think the Senate spoke clearly on this issue at that time, and this time, to ensure the constitutionality of the interstate compact, the Supreme Court has spoken, and I would see no need to include in my bill such a title. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, thank you. It's my pleasure for the second time this week to welcome Jim Baker before one of the committees I serve on, which causes me to reflect on two only somewhat related occurrences. One, some of the members of the Banking Committee may wonder where I have been as you, Mr. Chairman, conduct these hearings, and I have concluded you must have access to my schedule and schedule Banking Committee hearings so that they coincide either with the Finance Committee or the Aging Committee. Either that, or I have just been terribly unlucky.

The CHAIRMAN. No, it was Secretary Baker that had your schedule, because we originally had him scheduled at a different time. He chose today. [Laughter.]

Senator HEINZ. I was going to go on and say, Mr. Chairman, last week when this hearing was scheduled, it actually coincided with the hearings I had scheduled for this committee on the question of S. 635, the South African legislation, so actually, I suspect you haven't been getting my schedule.

Second, I just want to mention that Jim Baker did a virtuoso performance before the Senate Committee on Finance on Tuesday. He did an outstanding job of presenting the President's tax proposal, and I suspect that he will do no less in presenting his views before this committee.

I might add to the members that Secretary Baker is no novice in this area, although he does represent something of a rarity before this committee. He is a new face in this committee's panoply of witnesses on this issue.

I would note, Mr. Secretary, that we have had three Congresses full of witnesses before this committee on this subject—bank powers, financial services, regulation, deregulation—and it is nice to see a fresh face. But your views, I know, are not those of a novice, because you are a banking attorney, and I understand you practiced that considerably in your other life. I understand that you served on the board of a bank, and I understand that you are a grandson of a banker.

You are not a SOB, you're a GOB. [Laughter.]

Mr. BAKER. Thank you, Senator. [Laughter.]

Is that a "Good Ole Boy?"

Senator HEINZ. That, too. [Laughter.]

I'll leave the best interpretation of that to Phil Gramm.

But in any event, I just want to say, on a serious note, that one of the problems that we always have difficulty confronting—and I urge you to addres this today—is how, as we move forward to giving banks the tools that we all know they have to have to compete and remain sound and secure, can we retain fairness in the marketplace and safety for our banks. They are the custodians of the Nation's depository system, they are the instrumentalities we use to secure our payments system.

That is what makes the depository institutions special, not only because of that role, but because they are federally insured institutions. They have not only the benefit of Federal deposit insurance, but access to the Fed window and other advantages as institutions that we do not give to any other set of financial institutions or commercial institutions. How can we allow them into other lines of endeavor that are not closely related to banking, without creating competitive inequities for those other industries in which they might find themselves.

I hope you will address that issue, because it raises its head again and again. It is one of the most contentious issues that we have to deal with, and for my part, I must tell you that there has to be a very good reason to allow depository institutions into other lines of financial endeavor because of that.

So I welcome you to the committee and welcome you to the debate that we have on an annual and biannual basis, and we'll see you again next year and the year after that.

The CHAIRMAN. Senator Hecht.

Senator HECHT. No statement, Mr. Chairman.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. I'd just like to welcome our distinguished Secretary of the Treasury to the committee. I came here to listen to him and not to myself, and I'm sure I'm joined in that by many people who are here. So I look forward to hearing his views.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Senator Gramm couldn't have stated it more eloquently.

The CHAIRMAN. After that statement, you wouldn't dare say anything anyhow. [Laughter.]

Senator D'Amato was unable to stay. He does have a statement. I'd ask unanimous consent that his statement be placed in the record prior to the Secretary's testimony.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, before we begin I would like to commend you for conducting this informative set of hearings concerning competitive equity in the financial services industry. Mr. Chairman, I would also like to thank Secretary Baker for taking time from his busy schedule to take part in the Senate Banking Committee's oversight hearings on financial services.

There is a definite need for stabilization in the financial services industry. The current system in this Nation is showing severe signs of stress. There has been a great deal of rumbling in the financial services community on a wide range of issues, including disturbances in the Government securities market, foreign loans to developing nations, and the recent widespread failures of privately insured savings and loans in both Maryland and Ohio. These and other recent events have given those concerned with the well-being of the financial services industry reason to worry.

I believe there is a definitive need to steady the financial services industry. This important set of hearings provides a competent examination of the industry and, hopefully, can be used to provide a safer and more equitable system.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, please proceed.

STATEMENT OF JAMES A. BAKER III, SECRETARY OF THE TREASURY

Mr. BAKER. Mr. Chairman and members of this distinguished committee:

It is a pleasure to be here this morning to present the administration's views on the need to reform the financial services industry in a way which promotes the safety and soundness of our financial system while still advancing competitive equity among institutions as well as consumer convenience and welfare. I greatly appreciate the chairman's willingness to accommodate my schedule by allowing me to appear at this time rather than earlier in the hearings.

The administration has worked closely with you and the other members of the committee in recent years to achieve important banking reforms and to define the agenda for future reform. In my new capacity as Secretary of the Treasury, I look forward to an even closer relationship with the committee.

NOTABLE PROGRESS FROM COMMON EFFORTS

Notable progress already has been realized from our common efforts to modernize the structure of our financial markets. For ex-

ample, the nearly complete phasing out of deposit interest rate ceilings has permitted all our depository institutions to become stronger competitors for funds and has virtually brought an end to the once-serious problem of disintermediation. Also, with enactment of the Garn-St Germain Depository Institutions Act of 1982, our thrift institutions were provided the legal flexibilities needed by astute managements to maintain profitability throughout the interest rate cycle. Most recently, the Financial Services Competitive Equity Act, S. 2851, as approved by the Senate last year, laid out a comprehensive road map for the future that was largely in keeping with the administration's own principles originally proposed in FIDA.

I congratulate you, Mr. Chairman, and the committee, on your 89 to 5 vote in the Senate last year. S. 2851 embodied significant accomplishments that could not have happened without your leadership and the committee's hard work. Indeed, I think that all of our progress to date is indicative of the fact that the deliberative mechanism of Congress is effective and that future reforms ought to be realized likewise, rather than through excessive institutional experimentation or ad hoc regulatory initiatives.

Certainly, much remains to be done. Extending services to and protecting consumers, promoting competitive equity in product and geographic markets, updating and rationalizing the regulatory system, and reforming the deposit insurance system are issues that need to be addressed. I look forward to exploring these issues with the committee and am hopeful that, working together, we can adopt changes that will serve well the Nation's financial system and the public.

THE NEED FOR COMPREHENSIVE LEGISLATION

The administration's position on the need for comprehensive banking legislation is essentially unchanged from last year. Indeed, the need to modernize our banking laws and enable banks and thrifts to extend their activities to compete with other financial services providers is more important now than it has been during the last several years, given the rapid pace of changes in both technology and the marketplace. We generally supported S. 2851 and are prepared to support a similar bill this year. We have some suggestions for broadening the scope of permissible activities.

As you have noted many times already, Mr. Chairman, the issues are well-defined, thanks to the extensive hearings this committee conducted last year, and they have not changed in substance. As you have heard from every witness at these hearings, the events of the marketplace have pressured the regulatory system and may continue to do so. If Congress does not act to resolve the confusion in the financial services industry, we believe that a combination of State legislative initiatives and legal innovations arising from competitive pressures may cause further fragmentation of the financial system.

Some commentators are suggesting that, in light of the recent court decisions on nonbank banks, there is less of a need for prompt congressional action. I disagree. Court decisions, use of loopholes by aggressive financial firms, and regulatory actions are

no substitute for legislation. Only legislation can address, in a comprehensive and rational manner, the many complicated policy questions that are involved in delineating the future structure of the financial services industry.

In terms of priorities, we believe that any legislative action should be comprehensive. At a minimum, the new banking bill should authorize additional products and services for depository institution holding companies and address the questions of qualified thrift lenders, nonbank banks, and interstate banking.

Recent problems of privately insured thrifts in Ohio and Maryland underscore the need for restructuring our financial system in a manner which will enhance its viability for the future. Safety and soundness of the financial system is our highest priority. As we have explained more thoroughly in previous testimony, the holding company framework proposed by the administration in FIDA and incorporated in S. 2851 is designed to further that objective by insulating the federally insured depository from the potentially higher risks of nonbanking activities and thereby not increase the risk exposure of the Federal Deposit Insurance Corporation funds. The holding company requirement has the further advantages of preventing the federally insured depository from using its lower cost of funds unfairly to subsidize nonbanking activities and promoting equal regulation of functionally equivalent activites. We believe the holding company requirement is the best means, keeping in mind the objectives of safety and soundness, of providing financial institutions with additional product and service authority.

REASONS FOR NEW PRODUCTS AND SERVICES

There are a number of reasons why we believe banking organizations should be given authority to offer new products and services.

First and foremost, legislation that increases a holding company's product line would benefit consumers by providing them with a wider choice of financial services at competitively lower prices.

Second, new products and services would enable depository organizations to compete for customers on an equal basis with less regulated firms, thereby stemming the erosion of their customer base. One should not ignore the fact that today there are virtually no banking-type products or services that the securities and insurance industries cannot offer their customers. Outdated laws that continue to restrict banking organizations to offering customers strictly banking services only would perpetuate the market advantage that the securities and insurance industries already have. The result would be economic atrophy of depository institutions.

Third, the marketplace will not tolerate an irrational structure. As we have seen, consumer-driven market pressures inevitably find ways around laws based on artificial distinctions among financial service providers.

Finally, preempting State authority over State-chartered banks—for example, the Dodd amendment in S. 2851—is not, in our view, the best way to deal with the confusion arising from State deregulation. Such an approach is an unnecessary encroachment on the dual banking system, which is a vital source of innovation and dy-

namic competition. A better solution, we think, would be to take the pressure off the States by allowing banks to engage in new activities through holding companies.

In addition to the activities proposed in S. 2851, we would urge you to include two others: One, authority to sponsor, distribute and advise mutual funds, and two, authority to engage in activities of a financial nature as determined by the Federal Reserve. Both were proposed by the administration in FIDA. We believe that these two activities are needed to promote competitive equity and benefit consumers. Financial nature activities, in particular, would create a framework for depository institution holding companies to evolve with their competition.

Originally, the nonbank bank was viewed as a vehicle by which nonbank institutions such as retailers, securities firms, and the like could make a limited entry into banking. More recently, the nonbank bank has been viewed as a means by which bank holding companies could circumvent existing statutory restrictions on interstate banking provided the Federal Reseve authorizes them to do so. The nonbank bank loophole has been a source of confusion and competitive inequity. Nevertheless, it has created opportunities for enhanced product and geographic competition to the benefit of financial services consumers. The administration takes the position that these procompetitive benefits would be better realized in the form of expanded holding company powers and interstate banking.

We do not oppose the concept of a qualified thrift lender test like that proposed in S. 2851 to qualify for the unitary thrift holding company exemption. However, in the interest of competitive equity, we believe the exemption should be kept as narrow as possible and essentially be tied quite tightly to residential real estate lending. Savings banks should be required to have the same portion of their loans in residential real estate as savings and loan associations, but because of their traditionally more diversified portfolios they should be given a generous time period to reach that required level.

We continue to have serious reservations about the broad service corporation exemption because it permits some financial service firms to diversify within the depository institution rather than through the holding company, thereby creating competitive inequities between such firms and firms subject to holding company regulation.

Now that the Supreme Court has confirmed that States can join together to form regional compacts we believe Congress should turn its attention to the development of a trigger mechanism for nationwide interstate banking. The 5-year trigger adopted by the House Banking Subcommittee on Financial Institutions seems to me to be a reasonable time period for regional banks to make the transition to full interstate banking.

Mr. Chairman, in connection with relaxing the geographic restrictions on banking, there has been renewed interest in the limitations on financial industry concentration that you proposed in S. 2181 last year. Our position on this issue is unchanged. The administration is not convinced that size is inherently bad or that current antitrust laws are inadequate to deal with concerns about the potential for undue concentration of resources. Accordingly, we do

not believe that any restrictions on institutions size other than those under existing antitrust provisions are necessary.

EXTENSION OF NET WORTH CERTIFICATE PROGRAM

The emergency thrift acquisition and Net Worth Certificate Programs authorized by the Garn-St Germain Act expire in October 1985. S. 2851 did not consider the emergency acquisition provision that allowed for interstate acquisitions of qualified depository institutions. Given the need to protect the insurance funds and the administration's position that interstate banking should proceed as soon as possible, we would favor extending the conditions under which commercial banks can qualify for this program. Under current law, the FDIC can arrange for interstate mergers of qualifying open thrifts or closed commercial banks. The administration would permit interstate acquisitions of both qualified thrifts and commercial banks that are failing, but still open.

S. 2851 would have extended the Net Worth Certificate Program for 3 years and expanded it to include a small class of agricultural banks. Given the current condition of the thrift industry, the administration is willing to discuss a short-term extension of the Net Worth Program. However, broadening the program to include agricultural banks, as S. 2851 would have done, is not necessary, especially given the assistance already available to the agricultural sector.

There are two other issues we believe Congress should address in the near term, but only after it has resolved the issues I already have discussed.

First, while the Deposit Insurance Program has satisfied the goal of maintaining stability of the financial system over the past 50 years, there is concern that economic changes like volatile interest rates associated with changing levels of inflation, and the potential increase in riskiness of large institutions, may threaten the ability of the insurance funds to fulfill their goals. The administration addressed these concerns in a January 1985 report entitled "Recommendation for Change in the Federal Deposit Insurance System," prepared by a working group of the Cabinet Council on Economic Affairs.

The report contains recommendations relating to: One, risk-related premiums, two, a significantly higher capital requirement, three, consistent reporting requirements and prompt disclosure of material events, four, a review of the appropriate size of the funds and extension of insurance premiums to cover deposits payable in foreign offices, and five, continued improvement of the examination, supervision, and enforcement functions of the regulatory agencies.

This is the first time any administration has comprehensively studied the deposit insurance system. The study seems timely in light of the changing economic environment and recent problems in the bank and thrift industries. The administration's study is in addition to two earlier studies by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board that were required by the Garn-St Germain Act.

Second, the Vice President's Task Group on Regulation of Financial Services soon will transmit to Congress legislative proposals based on its July 1984 report, the "Blueprint for Reform." The task group's recommendations were unanimously adopted by the 13-member group and represent a balanced program for restructuring the financial services regulatory system. Enactment of the task group's proposals would significantly strengthen the effectiveness of the regulatory system, while at the same time reducing unnecessary costs for regulated firms. By improving our regulatory capabilities, the task group's proposals would help ensure the longrun stability of our financial system.

In conclusion, Mr Chairman, I again urge you to act soon on much-needed legislation to enhance the economic viability and thereby the safety and soundness of our financial institutions. Such legislation would also benefit consumers, promote competitive equity, and resolve the confusion in the financial services industry.

While there may be a consensus in Congress that loopholes must be closed, I believe there also is strong sentiment in the Senate and the financial services industry that a loophole closer alone will not suffice. We think it is important for the Congress to continue to demonstrate leadership on these issues.

We at the Treasury Department will assist you in any way we can.

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the committee may have.

[The complete prepared statement follows:]

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FOR RELEASE UPON DELIVERY
Expected at 9:00 a.m.
June 13, 1985

Testimony
of the
Honorable James A. Baker, III
Secretary of the Treasury
before the
Senate Committee on Banking, Housing and Urban Affairs

Mr. Chairman and members of this distinguished Committee:

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Notable progress already has been realized from our common efforts to modernize the structure of our financial markets. For example, the nearly complete phasing out of deposit interest rate ceilings has permitted all our depository institutions to become stronger competitors for funds and has virtually brought an end to the once-serious problem of disintermediation. Also, with enactment of the Garn-St Germain Depository Institutions Act of 1982, our thrift institutions were provided the legal flexibilities needed by astute managements to maintain profitability throughout the interest rate cycle. Most recently, the "Financial Services Competitive Equity Act" (S. 2851), as approved by the Senate last year, laid out a comprehensive road-map for the future that was largely in keeping with the Administration's own principles originally proposed in the "Financial Institutions Deregulation Act" ("FIDA", S. 1609).

I congratulate you, Mr. Chairman, and the Committee on your 89 to 5 vote in the Senate last year. S. 2851 embodied significant accomplishments that could not have happened without your leadership and the Committee's hard work. Indeed, I think that all of our progress to date is indicative of the fact that the deliberative mechanism of Congress is effective and that future reforms ought to be realized likewise, rather than through excessive institutional experimentation or ad hoc regulatory initiatives.

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We continue to have serious reservations about the broad service corporation exemption because it permits some financial service firms to diversify within the depository institution rather than through the holding company, thereby creating competitive inequities between such firms and firms subject to holding company regulation.

Interstate Banking/Regional Banking Compacts

Now that the Supreme Court has confirmed that states can join together to form regional compacts we believe Congress should turn its attention to the development of a trigger mechanism for nationwide interstate banking. The five year trigger adopted by the House Banking Subcommittee on Financial Institutions seems to me to be a reasonable time period for regional banks to make the transition to full interstate banking.

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industry, the Administration is willing to discuss a short-term extension of the net worth program. However, broadening the program to include agricultural banks, as S. 2851 would have done, is not necessary, especially given the assistance already available to the agricultural sector.

Other Issues

There are two other issues we believe Congress should address in the near term, but only after it has resolved the issues I already have discussed.

First, while the deposit insurance system has satisfied the goal of maintaining stability of the financial system over the past 50 years, there is concern that economic changes like volatile interest rates associated with changing levels of inflation, and the potential increase in riskiness of large institutions, may threaten the ability of the insurance funds to fulfill their goals. The Administration addressed these concerns in a January 1985 report entitled Recommendations for Change in the Federal Deposit Insurance System, prepared by a Working Group of the Cabinet Council on Economic Affairs. The Report contains recommendations relating to: (1) risk-related premiums, (2) a significantly higher capital requirement, (3) consistent reporting requirements and prompt disclosure of material events, (4) a review of the appropriate size of the funds and extension of insurance premiums to cover deposits payable in foreign offices, and (5) continued improvement of the examination, supervision, and enforcement functions of the regulatory agencies. This is the first time any Administration has comprehensively studied the deposit insurance system. The study seems timely in light of the changing economic environment and recent problems in the bank and thrift industries. The Administration's study is in addition to two earlier studies by the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board that were required by the Garn-St Germain Act.

Second, the Vice President's Task Group on Regulation of Financial Services soon will transmit to Congress legislative proposals based on its July 1984 report, the Blueprint for Reform. The Task Group's recommendations were unanimously adopted by the 13 member group and represent a balanced program for restructuring the financial services regulatory system. Enactment of the Task Group's proposals would significantly strengthen the effectiveness of the regulatory system, while at the same time reducing unnecessary costs for regulated firms. By improving our regulatory capabilities, the Task Group's proposals would help ensure the long-run stability of our financial system.

Conclusion

In conclusion, Mr. Chairman, I again urge you to act soon on much-needed legislation to enhance the economic viability and thereby the safety and soundness of our financial institutions. Such legislation would also benefit consumers, promote competitive equity, and resolve the confusion in the financial services industry. While there may be a consensus in Congress that loopholes must be closed, I believe there also is strong sentiment in the Senate and the financial services industry that a "loophole closer" alone will not suffice. We think it is important for the Congress to continue to demonstrate leadership on these issues. We at the Treasury Department will assist you in any way we can.

* * * * *

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Committee may have.

SAFETY AND SOUNDNESS ISSUE

The CHAIRMAN. Thank you very much, Mr. Secretary.

First, many in Congress have expressed concern about the safety and soundness of the banking system. I certainly share some of those concerns. Many have related them to deregulation. I personally do not believe anything we have done so far in deregulation or what is proposed adds to any safety and soundness problems, or I would not continue to support them.

But do you feel that expanding banking systems, securities activities—or I should say securities activities into separate subsidiaries of bank holding companies does in any way threaten the safety and soundness of those institutions?

Mr. BAKER. No, sir; Mr. Chairman, I don't. In fact, quite the contrary. It's my view that if it is done through the holding company system, you end up making banks more competitive and thereby in effect strengthen the system by hopefully enhancing their profitability.

The CHAIRMAN. You have recommended in your testimony today that banks be allowed, once again through the holding company, to sell mutual funds and to participate or engage in activities of a financial nature. Those were the words we originally had in S. 1609 and also in my bill. These were deleted simply because of the fact I have learned to count in this committee and there were not sufficient votes to pass them. The administration last year also recommended real estate brokerage, insurance sales, and underwriting.

Now it was not legislatively possible to include those last year and I doubt very much that this position has changed in the Senate or in this committee. But if it were legislatively possible, does the administration still support those other two activities as well?

Mr. BAKER. Mr. Chairman, I don't think that there has been any significant change in our position with respect to those two activi-

ties. I think it's more a case of our also being able to count and feeling, perhaps to a greater degree than we did before, that maybe the best way to proceed is to proceed a bit more gradually and try to do what might be doable.

We do favor including activities of a financial nature because we think the fact that the Federal Reserve would be the determining agency with respect to those activities would prevent any overly broad interpretation that might be opposed by many members of this committee.

The CHAIRMAN. Yesterday, as we have discussed, the House Banking Committee approved a bill on interstate banking with a 5-year trigger—a mandated 5-year trigger—and you have endorsed a mandatory trigger.

Do you feel in any way that that's a violation of State's rights, either the House action, or recommending of a mandatory trigger?

Mr. BAKER. No, sir, we do not.

The CHAIRMAN. You mentioned the administration's recommendation for a change in the Federal Deposit Insurance System. The report includes the need for improvement in the examination and enforcement function of regulatory agencies.

Do you believe there's a need to increase the enforcement powers of regulatory agencies?

Mr. BAKER. My view, Mr. Chairman, is that the regulatory agencies have sufficient enforcement powers. We do, as we point out in the study, favor the concept of a risk-related premium. We don't think the problem is so much a need for more enforcement as it is perhaps strengthening some of the powers, as we discussed in the testimony.

The CHAIRMAN. Do you feel that improvements are needed in the examination function?

Mr. BAKER. I don't think we need any improvements in the examination function, no, sir. I'm not aware of any that are needed.

The CHAIRMAN. Do you feel the timing is adequate? Let me refer back specifically to Penn Square. I suppose that's what prompts the question. Both Penn Square and Continental Illinois, talking about the examination functions.

Mr. BAKER. I'm sorry, Mr. Chairman. I thought you were talking about legislative improvements in examination functions. Sure. I don't mean to suggest that there's not always room for improvement with respect to the performance of its responsibilities by any Federal agency. I suppose the regulators could find room for improvement also. I thought you were suggesting legislative changes.

The CHAIRMAN. No, not at this time. That's why I was surprised at your answer and was going to give you some specific examples of the long timeframe in the *Penn Square* case. The examination process knew there were problems and yet, suddenly, it seemed to be a surprise to some in Continental Illinois, specifically talking about changing schedules of examinations, and concentrating examiners on troubled institutions, rather than continue to examine State-owned conservative institutions, and possible recommendations for higher salaries and more examiners.

Some of the complaints you get obviously are that we start with brand new people at entry level. They don't have the background and experience, those types of things.

Mr. BAKER. Mr. Chairman, I wouldn't argue at all with the notion that there is room for improvement in the examination function. I'm sorry, I thought you were suggesting legislatively mandated changes.

The CHAIRMAN. I'm going to stop my questioning at this point. We do have a problem that I think everybody is aware of, after this hearing was scheduled.

We have a joint session of Congress and so I have a large number of questions. Most of them, I will submit to you for response in writing so that we will not be rude to the Prime Minister of India.

Before I do that, let me announce that the previously scheduled 11:30 hearings on South Africa sanctions legislation, because of the joint session, has been postponed until 11:45 in deference to the 11 o'clock joint session to hear the Prime Minister of India.

Senator Proxmire.

INTERSTATE BANKING

Senator PROXMIRE. Mr. Secretary, as I indicated earlier, I am disturbed about the interstate banking threat. Let me give you an example. We have in Wisconsin a little town of about 2,000 people. Before I came to the Senate, I happened to be a half-owner of a printing company there. We had a bank in that little town that did an excellent job.

The bank is owned by 100 people who live in that little town of 2,000 people. It's obviously community-owned; it serves the community. The people who run the bank and own the bank know the people in the community very well.

This isn't the case in any other country in the world. In Canada, in England, France, Italy, Japan, they have three or four or five big banks and they have branches all over the country.

I think this local ownership is so critical, having the people who own the bank and know the people in the community, their character and not just the numbers on the operating statements of the balance sheet, but to know them is invaluable. And it seems to me interstate banking represents a real threat. They think it's a threat. I have talked to these people in my State and they are deeply concerned, not just the bankers but the local business people are concerned about it.

They think maybe their local bank could survive, maybe it couldn't. But aren't we moving pretty fast without any real study that shows that local ownership resulted in higher interest rates, or unavailable credit?

If somebody living in Waterloo, WI, wants credit and can't get it for some reason with a bank there, they go 4 miles away to Marshall and get it, or they can go 13 miles away to Watertown and get it, or, if necessary, to Madison, which is only 15–20 miles away; or to Milwaukee.

As I say, I have done business in that town. We borrowed money from that bank and I think it's typical. The banks in Texas, banks in Connecticut, Utah, Pennsylvania, and all over this country.

So I'm concerned about that. What's your answer to this?

Mr. BAKER. You're quite right, sir, with respect particularly to my home State of Texas, and I know there's been concern in the

past. I am not sure of the extent to which in the countries you mentioned—such as Canada and Britain, where you have concentrations of banking power in the hands of five or six major institutions—there has been in the past a competition with banks by other financial service organizations.

We certainly have that competition today and, as my statement indicated, we are concerned about an atrophy of depository institutions by virtue of their inability to compete.

Now, under the bill that was passed by the House, if I understand it correctly, no States would be subjected to interstate banking unless they participated in a regional compact. They could in effect opt out of nationwide banking by not authorizing regional banking.

So if the State wanted to protect the local banking system in the manner in which you have suggested, they would be free to do so. I realize we are supporting the concept of full interstate banking, but the bottom line, I suppose, is I do not believe that it would be a problem.

I don't think that bigness per se is bad and I do believe the antitrust laws on the books today would be sufficient to take care of problems of undue concentration of power and that sort of thing.

Senator PROXMIRE. Well, I would hope so. But the antitrust laws have been very weak in some respects, as you know. We have an automobile industry that's dominated by three enormous companies and in many other areas we have a very, very high concentration. Not in finance.

The 10 biggest banks in this country do only 30 percent of the business and the other banks do the rest.

ADMINISTRATION SUPPORTS NATIONWIDE TRIGGER

Let me just refer again to your statement on page 5. You seem to indicate the administration supports a nationwide trigger on interstate regional banking companies.

As I understand it, the effect of a national trigger would be to force the State that wanted to take part in regional banking to go to nationwide banking within 5 years whether it wanted to or not.

Now, on page 4 of your statement, you oppose the Dodd amendment, that Senator Chris Dodd, who is here this morning, is the author of. You oppose it because it interferes with the right of a State to allow State-chartered banks to offer insurance services to residents of their own State.

That seems to me to be inconsistent. Why are you so concerned about State's rights on the Dodd amendment but are willing to override the State on interstate branching?

Mr. BAKER. Well, sir, I would not argue that it isn't inconsistent. I think it is. I think, though that the two situations perhaps are different. I think that there can well be instances where you would support a principle even though it might run counter to a principle that you supported in another situation.

That's the best way I would explain it to you, sir.

Senator PROXMIRE. You mean, sometimes we all have to rise above principle? [Laughter.]

Mr. BAKER. Well, I guess that's right.

Senator PROXMIRE. Last year the administration recommended a comprehensive deregulation bill that would have allowed bank holding companies to engage in a wide variety of new activities. Most of these proposals were rejected by the Senate Banking Committee.

I'd like to go down the list and find out if the administration still supports banking in these areas through the holding company device: First, insurance underwriting.

Mr. BAKER. No, sir, not expressly as such. We do support the concept that holding companies should be permitted to pursue activities of a financial nature as defined by the Federal Reserve.

I can't tell you here today whether the Federal Reserve would or would not conclude that that type of activity is of a financial nature, but we did not include it expressly as we did in FIDA because, as I said earlier, we can count and we think it's better to crawl before you walk and take these things a bit more gradually than we were looking at a year or so ago.

Senator PROXMIRE. I'd take it you'd give me the same answer on insurance brokerage?

Mr. BAKER. Yes, sir.

Senator PROXMIRE. Real estate development?

Mr. BAKER. The same.

Senator PROXMIRE. Real estate brokerage?

Mr. BAKER. The same.

Senator PROXMIRE. Acquisition of savings and loan associations?

Mr. BAKER. No, sir. We support that.

Senator PROXMIRE. Mutual funds?

Mr. BAKER. No, sir. We are suggesting mutual funds be included as an expressed power.

Senator PROXMIRE. How about other services of a financial nature?

Mr. BAKER. We are supporting that.

Senator PROXMIRE. What are the specific activities of a financial nature that would be authorized by the Federal Reserve that cannot be authorized under the current statutory language?

Mr. BAKER. Well, the current statutory framework, if I'm correct, permits them to authorize activities which are closely related to banking. I'm not in a position, sitting here this morning, to tell you what the Fed might or might not determine to be activities of a financial nature that are not activities closely related to banking, but it would give them more latitude, Senator, to permit banks to become more competitive and it would protect the banking industry against some particular service or activity that might arise in the future, that the Fed could then permit as a matter of competitive equity to banks.

Senator PROXMIRE. Would you construe all the ones I have mentioned as service of a financial nature—insurance underwriting, insurance brokerage, real estate development——

Mr. BAKER. As I say, I would refrain from making that construction. I think that's a matter that would be left under our proposal to the Fed and I couldn't prejudge that.

Senator PROXMIRE. But that would be possible?

Mr. BAKER. It would be possible, yes, sir. And the reason, for instance, that we asked for insurance and real estate in FIDA was to

make it clear that we wanted those powers at that time and did not want to leave that up to the discretion of the Fed. Conceivably, therefore, the Fed could determine that those two activities are not embraced within the meaning of that phrase.

Senator PROXMIRE. Let me get into one other area very quickly because I realize time is short this morning.

As you know, Paul Volcker and SEC Chairman John Shad, among others, have expressed considerable concern about the leveraging of corporate America resulting from recent hostile takeovers and leveraged buyout activities. How concerned are you about the debt being incurred by target companies such as Phillips and Unocal, and how active do think banks should be in lending to finance this type of activity?

Mr. BAKER. We are not overly concerned, Senator Proxmire. We do believe that the regulatory—the deposit insurance—authorities can in effect protect themselves through regulation, that is, that the depository institutions, to the extent that they should not engage in activities of a risky nature, if indeed those are such, could be protected through regulation. So we have proposed no legislation in this area.

BUILDING PYRAMIDS OF PAPER

Senator PROXMIRE. The argument has been made that much of this activity is being financed by mirrors; that is, transactions subject to financing where no real money is put forward and that we are building pyramids of paper and that many of these transactions will hurt us, next recession.

What's your view and what is the administration's policy regarding what should be done in this area, if anything?

Mr. BAKER. Well, my view is, as I've just stated, we should not legislate in this area. We should leave it to the insurance authorities, the regulatory authorities to act if they think it's important to protect the fund.

Senator PROXMIRE. Do you see any abuses at all in the takeovers that we should enact legislation to try to overcome?

Mr. BAKER. We studied this in a Cabinet Council and submitted recommendations to the President which he adopted, Senator, to the effect generally there are no major abuses that we see. We would be concerned about risk to the insurance funds, but we think that the authority is already there on the part of the insurance agencies to protect themselves.

Senator PROXMIRE. Thank you.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you very much.

Mr. Secretary, last year, as you know, the committee decided against granting insurance and real estate powers to the banking industry. The administration takes a different point of view. Nonetheless, if the committee reaffirms, as I suspect it will, that limitation on banks, would we not be making a serious mistake, in fact undercutting the decision of the committee, presumably the Congress, if we allow State legislatures and bank regulators to make decisions that will allow State-chartered banks to go into real estate brokerage or insurance activities of one kind or another?

Will that not ultimately generate pressure in the same way as the misconstruction of the language on nonbank banks, which I believe was misconstrued by the Comptroller? Could State action generate pressure on us to do something we don't think we want to do at the Federal level?

Mr. BAKER. I think that may well be the result, Senator Heinz. We have a very difficult problem and it seems to me we've got to balance States' rights in a dual banking system against the Federal interest in insuring these institutions. We have called for the imposition or at least the consideration of risk-related premiums designed to, in some way, protect the deposit insurance funds against those risks.

In addition, I would suggest it would be our view that Congress should look closely at those activities of federally insured State-chartered institutions which are authorized by the States but which are not authorized for federally chartered institutions by the Congress. I think it's something that bears looking into.

We have no specific proposal, however.

Senator HEINZ. On the other hand, the administration takes, as I understand it, a somewhat different view on the application of limitations on securities powers of banks. You may be for banks selling mutual funds, but I don't think that the administration has any desire to see banks underwrite securities generally.

Mr. BAKER. We are not presently supporting that, Senator Heinz. We think that the additional powers which we are supporting as enunciated in my statement—that is, the three that are in S. 2851 plus mutual funds and activities of a financial nature—are a sufficient step at this time and that we should not go any further.

We should see first how we do, if indeed we take that step—see how it works before we go any further.

Senator HEINZ. Now the logic—and you're not the first to advance it by any means—of expanding those bank powers is, as you say on page 2 of your statement, to increase competition. Yet I don't know of anybody—and I suspect you would end up putting yourself in the category—who says that additional competition in the real estate and insurance industries is in fact necessary. You do not contend that there is an insufficiency of competition in either of those endeavors, is that right?

Mr. BAKER. No, sir. It's simply a case that there are others in the financial services industry who are engaging in those endeavors, others who compete with banks in their depository functions, and as I indicated in my statement, we are concerned that we will tend to see an atrophy of the banking institutions if we don't permit them a bit more competitive equity.

I am not suggesting that there is not adequate competition in the real estate and insurance industries. I'm looking at it from the other end of the spectrum.

Senator HEINZ. That's what I thought. Looking at the issue then, that's probably the nub of the issue, banks are atrophying, becoming less of a factor in our financial system, somehow losing their ability to be responsive to the needs of the economy. Is there any evidence that banks in fact have been losing share of market through this wave of innovation in the financial marketplace?

Mr. BAKER. Well, I can't refer you to a specific study. It may be that the Comptroller's office or somebody——

BANKS SHARE OF MARKET STEADY AT 36.7 TO 39.5 PERCENT

Senator HEINZ. Let me bring to your attention the latest information I have which is a Federal Reserve Bank of Minneapolis study which states that the bank market share of total financial assets has maintained at a steady rate of between 36.7 and 39.5 percent in the period 1960 through 1982. And since then, it's my understanding that banks have had, according to the Comptroller, banks have had some pretty good years.—I'm sorry, according to the head of the FDIC, Bill Isaac. He stated that the vast majority of banks are in remarkably good shape, problem banks still constitute only a small percentage of the total and the failure rate of one-half of 1 percent remains well below that of any other industry. He stated that earnings have held up well and banks, particularly the larger ones, have added substantially to their capital base.

If that's true, why should we—if the goal is to help banks because they need help—I emphasize the word need—what I have described is in fact accurate, what is the need?

Mr. BAKER. Well, I think that just as a matter of competitive equity, Senator, that we ought to permit banks to engage to the extent that we can, with safety and soundness as our foremost concern as I indicated in my statement, to engage in those activities that their competitors engage in, consistent with safety and soundness. No one would deny, and I'm sure Bill Isaac wouldn't deny, that there have been some strains in recent years with respect to some banks. I mean, yes, the banking system is in good shape and I'm not suggesting otherwise. But I think we also should recognize that there have been, at least in the last couple of years, a number of failures in the system. I'm not suggesting that those failures are due entirely to the fact that banks can't compete because they are due, I think more likely than not, to poor lending practices, to banking on a continuation of inflation which didn't happen and that sort of thing.

Senator HEINZ. If depository institutions weren't shored up, protected and so forth by Federal deposit insurance, the Fed window and so forth, I think you would have a much stronger case, perhaps an airtight case, because then you would have some difficulty saying that one set of institutions is very unlike another, but we do have what I've just described. The administration attempts to solve that problem by setting up a bank holding company and subsidiary requirements.

Mr. BAKER. Yes, sir.

Senator HEINZ. Yet last year when Continental Illinois got in trouble, we didn't rescue the Continental Illinois Bank. We rescued the holding company. And it seems to me that that validates the testimony of literally dozens of witnesses we've had before this committee, including Paul Volcker as I recollect, who have said:

Look, it really doesn't make any difference whether you establish separate subsidiaries or not. The bank is the thing and you can pretend that you're somehow separating one subsidiary from another through the holding companies, but the fi-

nancial advantages, strengths and weaknesses of banks and their holding companies are so intertwined that in fact that is a false distinction.

What do you say to that?

Mr. BAKER. I do not think that is a false distinction at all when you relate it to the objective of protecting the insurance fund, which is the major objective that you have in mind—protecting the insurance fund and making certain that you don't have an unfair allocation of credit to affiliates, that sort of thing. I mean, I simply would disagree with that, Senator.

I think the holding company concept is——

Senator HEINZ. Then why was it necessary to save the holding company in Continental Illinois?

Mr. BAKER. Because there was, as I recall it—and I didn't work on that problem at all back then——

Senator HEINZ. Lucky you.

Mr. BAKER. As I recall it, there was a requirement in its loan agreements that it could not alienate the bank stock and it was impossible for the FDIC to take over the bank stock without taking over the holding company so they took over the holding company.

But my point is, there is an important objective that is served by requiring a holding company in terms of protecting the insurance fund.

Senator HEINZ. Mr. Secretary, you normally are an awfully persuasive person. On that one, I don't think you have lived up to your normal high standard of persuasion. But I thank you for making every effort to do so and my time has expired.

The CHAIRMAN. He persuaded me.

Senator HEINZ. Well, you're easy to persuade sometimes. [Laughter.]

The CHAIRMAN. Before I turn to Senator Dodd, Senator Dixon was here earlier and I would ask unanimous consent that his opening statement be placed in the record prior to the testimony of the Secretary.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. I am pleased we have this opportunity to hear from the distinguished Secretary of the Treasury, James Baker, on the need to reform the financial service industry statutory framework.

As I'm sure the Secretary will agree, the time to act is now. In fact, the truth is that we should have acted already. We need to deal with the nonbank bank question and end the practice of making policy by finding loopholes in existing statutes. We need to provide banks with the new asset powers they need to be able to compete in a rapidly changing marketplace. We need to extend the net worth certificate program for the thrift industry. We need to address all the issues raised by S. 2851 which passed the Senate by an overwhelming 89 to 5 vote last year.

This committee has listened to numerous witnesses and compiled thousands of pages of testimony over the past few years. We have all the information we need to again report to the Senate a bill similar to last year's bill.

As I have stated on a number of previous occasions, I believe that there are additional issues this committee must soon begin to move forward on, including questions involving deposit insurance and whether premiums should be risk related, questions involving the FSLIC fund, and issues arising from the Vice President's report, to name just a few. These matters, however, can be handled in a separate bill without delaying action on the issues the Senate decided so decisively last year.

I look forward to Secretary Baker's testimony this morning, and I hope, with his help, to get badly needed financial services reform legislation enacted as quickly as is possible.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. I would ask unanimous consent that a statement of mine be included in the record at this point.

The CHAIRMAN. Without objection.

STATEMENT OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Mr. Chairman, I want to join my colleagues in a warm welcome to Secretary Baker in his first appearance before us.

Mr. Secretary, you come before us at a critical time in the history of our financial institutions. Over the past decade or more, technology, inflation, innovative attorneys, and other factors have combined to radically alter the face of our financial institutions. We have more and more nondepository institutions engaging in banking type activitives. And we have more and more banks pushing the limits of existing laws to engage in activities not traditionally permitted to banks.

It is not surprising that all these changes have placed enormous stresses on the system. While some competitors have been very successful, others have been having major troubles—from insurers to brokerage houses to banks and S&L's.

What concerns me most are the depository institutions, because of Federal deposit insurance. Over the past 4 years, we have seen almost one-fourth of our S&L's disappear and we now have enough S&L's in such serious trouble that the FSLIC fund is not nearly strong enough. Less than 2 weeks ago, seven banks failed in a single day and we are well on our way to a record number of bank failures this year.

The explanations for these occurrences vary. Different people have made plausible arguments for widely varying causes—from the abuse of existing authorities such that it would be unwise to give banks new powers to the inadequacy of existing authorities, leading banks to take greater risks because they cannot invest in different products that would improve their yields at lower levels of risk.

I might add at this point that had banks been in the business of underwriting property and casualty insurance last year, they could have joined in the losses that ran to almost $3 billion. They would have been better off investing their money in passbook savings accounts.

But my point is a simple one. I think it is essential that this committee conduct a comprehensive investigation of the causes of the stresses in the system before we take any action. I would be hopeful that we could act with sufficient speed that we could consider comprehensive legislation in the second session of this Congress but if we cannot, I would urge us to plug all the loopholes so that when we legislate comprehensively, we will not have to deal with institutions that have gotten around existing law by loopholes and present hard situations for us to deal with equitably in legislation.

In closing, I just want to say how delighted I am with the Supreme Court's decision on regional banking. It will give the States the opportunity to act as laboratories for a possibly very important development in banking without posing any risk to the safety and soundness of our banking system.

Thank you, Mr. Chairman. Welcome, Secretary Baker.

Mr. Secretary, let me welcome you to the committee. On your first appearance, it must be pleasant to have a reprieve from taxes in view of the events of the last couple weeks, and come to what we affectionately call the real world here dealing with financial institutions.

Mr. BAKER. Taxes and multilateral development banks and a few other things.

Senator DODD. I understand. Let me get to what seems to be an underlying question here and it's been raised by others on the committee here this morning and it's the question that I think all of us are wrestling with, and that is, exactly what is going on?

NEED TO TAKE AN INDEPTH STUDY OF THE PROBLEMS

I have certainly spoken to any number of people who believe that the situations in Maryland, Ohio, and elsewhere can be explained because of the unique sets of circumstances that have occurred, through either mismanagement, fraud, or a variety of other things they can be explained as causing those particular circumstances. There are others who believe that there is a systematic problem that Ohio and Maryland are illustrative of but certainly we're not seeing the end of the problem at all, that it is much broader based, more widespread, and more serious. You have alluded to that yourself just going back and forth.

It seems to me—and I don't disagree with you on the notion that we ought to try and get about the business of legislating things here rather than leaving them up to the courts and leaving these questions open-ended, but I'm concerned a bit that no one seems to be certain at all as to really what has been going on and why these problems have occurred and whether we've seen the end of it or not.

I talked last evening with a person from the banking industry in your home State who expresses the view that he thinks it's widespread, doesn't think it's limited to a couple of situations that we're going to have to deal with and that will be pretty much the end of it at all.

As far as I know, the Treasury has not done any comprehensive analysis of the problem. Wouldn't it make more sense—this is what I'm getting to—wouldn't it make more sense for us to take the 6

months or so, whatever it would take—maybe less than that, I presume—to really examine this issue thoroughly before we decide to sort of charge ahead legislatively without being fully aware, or fully conscious, or knowledgeable about why these problems have emerged? What is inherently wrong I suppose with that idea of really trying to understand this, since there seems to be so many people who disagree as to what is actually going on?

Mr. BAKER. Senator, I think you have such a mish-mash of regulations and conflicting jurisdictions that, as I indicated earlier, we ought to recognize the fact that we have to crawl before we walk, and if we're going to get a handle on this problem, we ought to start somewhere.

We have been studying it now in terms of trying to come up with legislation for 2 or 3 years and we haven't been successful. I think the actions yesterday in the House are encouraging in terms of at least taking some actions in the banking area.

You raised the question of the failure of State-insured thrifts. That's an entirely separate and different question it seems to me that we should deal with, but I don't think that argues for not moving forward where we can move forward.

So I would hope that we would move forward in an area that we've been looking at now for 2 or 3 years.

Senator DODD. Well, if you take just—I know you argue here and I don't take it personally at all—the South Dakota loophole question, there is a classic example where we're going to allow a major loophole that allows States in effect to determine all sorts of potential activities which would undercut the very thing you're suggesting that we legislate to take some action to try and frame this thing in a tighter fashion. Otherwise you would allow for open-ended avenues for States to go off on their own pretty much without of course assuming the risks.

STATES SHOULD ASSUME SOME RESPONSIBILITY

Mr. BAKER. Well, I just said earlier that I think that's something that Congress ought to take a look at. I suggested that we should take a look at that. We have specifically called for a risk-related premium approach and I suggested that Congress should take a look at the activities of States permitting depository institutions to do things that are prohibited at the Federal level by Federal laws to Federal institutions, and we support the Garn bill's provision with respect to the South Dakota loophole, the extraterritoriality effect of permitting a State to charter an institution to conduct activities only outside the State.

Senator DODD. I don't have any problem with the State legislature allowing State-chartered institutions to do anything they want at all, provided those States are also willing to assume the risks and they don't get the advantages of the Bank Holding Company Act. There are tremendous tax advantages associated with that. It seems like you can't have it both ways.

Mr. BAKER. You mean the risk as far as insurance is concerned?

Senator DODD. Sure. I mean, they've got to assume a lot of the responsibility there.

Mr. BAKER. We see eye to eye on that.

Senator DODD. Let me ask you this as well. Are you saying in effect—I don't want to put words in your mouth, but it seems to me you're saying that part of the problem has been with Continental, Penn Square, Maryland, Ohio, and so forth is that there's been too much regulation. Do you believe that?

Mr. BAKER. No, I'm really not saying that. I'm not suggesting that Penn Square failed because it wasn't competitive and it didn't have a fair shot. I'm not suggesting that about Continental Illinois either. I am suggesting that we have some rules and regulations respecting depository institutions that have been on the books for a long, long time and that the growth of the financial services industry in this country is such that there are now organizations competing with those depository institutions that are not subjected to those rules and regulations and they have a competitive advantage.

I think the Penn Square and some of the other bank failures are due, as I indicated, to poor lending practices, to counting on inflation in the areas of energy and agriculture, and when inflation didn't continue a lot of people got caught.

Senator DODD. Well, my time is going to run out shortly. Let me ask you one other question on the interstate banking.

You propose a 5-year sunset provision. I don't have a real problem with the idea of 5 years. I am a little uneasy about legislating it. The beauty of the regional banking approach is that it will allow us to sort of test out theories as to whether or not this makes a lot of sense. We will find out pretty quickly whether or not this is going to work very effectively at all and it was only a few short years ago that if you had even suggested regional banking to the States you would have been considered anti-States rights and a lot of other things. So we seem to be moving—the attitudes seem to be moving in the proper direction. I'm just concerned about the idea of legislating or locking us into a 5-year period.

Wouldn't it make more sense to maybe just talk about the idea of moving toward interstate banking rather than trying to commit ourselves to a time certain?

Mr. BAKER. Well, if you just talk about moving toward it, what does the law say? What would the statute say?

Senator DODD. Well, I think it would be that that is a policy statement rather than to lock us in.

Mr. BAKER. I see. Well, I think we would favor moving a little bit more aggressively there, Senator. We support the concept of interstate banking, particularly recognizing as I indicated to Senator Proxmire, that States can opt out. The trigger is a 5-year trigger, yes, but if the State doesn't enter a regional compact, as I understand it under the House Banking Committee bill, they're out.

Senator DODD. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

I'm a little curious about your response to the problem you see raised when other institutions compete with depository institutions, as you say, undercutting their base. I take it that's your perception of the current situation; is that right?

Mr. BAKER. Yes, sir.

REMEDY IS TO EXPAND ACTIVITIES

Senator SARBANES. Why do you think the remedy to that is to expand the activities of depository institutions, rather than to curtail the activities of other institutions which have moved into areas they traditionally had not been engaged in.

Mr. BAKER. Well, Senator, what we're talking about here in terms of expansion is expansion into activities really that are incidental only to activities that banks already undertake, and it seems to me that, try as we might, to restrict the kind of operation, for instance, that Sears is engaged in, we would find it exceedingly difficult with the mish-mash of conflicting jurisdictions and regulatory authorities to ever come up with a regulatory scheme that would be effective.

It would seem to me that the lawyers——

Senator SARBANES. Do you think insurance underwriting and brokerage is one such activity?

Mr. BAKER. Such activity of what? Of a financial nature?

Senator SARBANES. Yes, into which the banks should expand?

Mr. BAKER. No, sir. We supported that in our earlier proposal, FIDA, because, as I understand it we wanted to expressly make it clear that those two activities would be permitted to banks. We have come off of that position because, as I indicated earlier, we can count and we think Congress ought to pass a bill and move in this area and take a step and it's clear that you're not going to take these steps, and so we have deleted insurance underwriting and brokerage as powers we seek.

Senator SARBANES. Well, of course, that is a mish-mash, too, only in this instance it's a political mish-mash. In other words, if the reason you're coming off that position is essentially because, as you say, the votes aren't there and not because it represents your idea development of what you think the rational structure of the financial industry ought to be, it seems to me we have to get some idea where all this is taking us. If you're starting down this path and saying, well, we're not going to lay out the full plan because some of it is not politically achievable, although that's an essential part of where we want to go, it seems we need to know that. In other words, where is all of this going to take us? What is the structure of the industry you foresee at the end of the path, you project? I'm not asking about the current movements that you're prepared to support as a political mish-mash, so to speak. Where do you see us going? Would you do away with Glass-Steagall, for instance?

Mr. BAKER. No, sir, that's not what we're calling for, although the powers that we have asked for I suppose we would characterize as selective exceptions to Glass-Steagall. I think we would anticipate a mix of large, medium, and small commercial banks and thrifts and thrift holding companies operating nationwide, regionally and locally. I think that's where we're ultimately headed.

Now again, we won't get there unless we have legislation and unless we take the first step, and it seems to me that suggesting that banks engage in underwriting municipal revenue bonds, commercial paper, and mortgage-backed securities, as well as mutual funds, is not a giant—not an overly giant step. Those activities are incidental to activities banks are already engaged in. But it will

move us toward a more competitive marketplace in financial services.

Senator SARBANES. Well, now as the follow-on steps to those changes, if made, what would the follow-on steps be?

Mr. BAKER. Well, after we had seen the experience resulting from those activities for a period of time it might well be that we would come back and repropose insurance and real estate as we had proposed several years ago in FIDA, but I can't judge that now.

Senator SARBANES. Would you also anticipate proposing the elimination of the distinction between commercial and investment banking which Glass-Steagall established?

Mr. BAKER. No, sir, we have not suggested that.

Senator SARBANES. Why not?

Mr. BAKER. Because we think that that distinction has served a useful purpose and function and we are not suggesting that it be eliminated. What we are suggesting is that there be certain selective exceptions made to it, that we judge what happens in the banking industry and in the overall financial services industry as a result of those exceptions, and then move later if indeed we need to take further steps.

Senator SARBANES. Well, where is it you want to move? What will the financial structure look like at the end of this process of change?

Mr. BAKER. Well, if we pass what we are suggesting here today, we will have made these selective exceptions and we will not have made, in my view, dramatic changes in the structure of the financial services industry. They would be important ones, significant ones, but certainly not as dramatic as what the Treasury suggested and proposed in FIDA.

TREASURY'S NEW POSITION

Senator SARBANES. In other words, you regard the position you're taking now as substantially different from the previous Treasury position?

Mr. BAKER. I think it is different from the previous position. There, we wanted to expressly spell out that banks would be entitled to engage in the insurance and real estate business. Here, we are not asking for those powers. If the Fed determined at some future date that those were activities of a financial nature, then I suppose they would be included, if the committee and the Congress decided to add activities of a financial nature.

The CHAIRMAN. If the Senator would yield for just a moment, under that definition, under title VI of Garn-St Germain, insurance was specifically prohibited. The Fed could not, under that recommendation where you're talking about financially related—Title VI of Garn-St Germain, prohibit the Fed from doing that. So the Fed could not make that judgment under the recommendation of the Secretary today.

Mr. BAKER. I understand that, Mr. Chairman. We do differ there, too, in terms of that prohibition, as I indicated in my statement. I was speaking in light of what the situation would be if our proposal became law.

The CHAIRMAN. I understand. I just wanted everybody to know that was a proposal and under current law the Fed would not be able to do that.

Senator SARBANES. Mr. Secretary, let's just take insurance as an example, although there are others—this is a more far-reaching issue but in this area, your judgment is not that the depository institutions should not be able to engage in that activity?

Mr. BAKER. That's correct.

Senator SARBANES. You're not proposing that, I take it, because as you said a little earlier you can count votes. So what you're really proposing is the possibility of achieving it indirectly, as I understand it, by giving to the Fed the authority to sanction activities of a financial nature of which, using this example, insurance might be such an example. Is that correct?

Mr. BAKER. Yes, sir. I'm acknowledging to you that it would be possible that the Fed might make that interpretation. I just can't judge—I'm not in a position to judge what they might or might not do, but I am acknowledging that that is possible. We are not coming in and expressly asking for that power as we did before, either one of those powers.

Senator SARBANES. It's raising the opportunity to accomplish by indirection what you've judged cannot be accomplished directly at this time. Is that correct?

Mr. BAKER. Well, that may be one way to characterize it. I'm simply, I like to think, laying the cards on the table and saying, look, the activities of a financial nature might be construed to include those two things, so we all ought to recognize that. I think we all do anyway.

Senator SARBANES. I want to address the assumption that the holding company technique is adequate to provide for safety and soundness in terms of insulating the various activities. I take it that's the Treasury's position; is that correct?

Mr. BAKER. Yes, sir.

Senator SARBANES. Now Mr. Wiston, who of course wants to move in all these areas but at least is pretty candid about admitting it, has been quoted by in the debate frequently as pointing out that if the name is on the door they will use all their resources to support the name. In other words, the distinction really will not work in practice, and therefore the supposed protection for depositors on the safety and soundness side runs the risk of being compromised even if you're using the holding company technique. I mean, how can they run the risk of the holding company encountering difficulty and not having that spill over to the depository institution?

Mr. BAKER. Well, because it is a separate legal entity and the insurance fund, I think, is significantly protected by the holding company approach. I had a discussion of that earlier with Senator Heinz and I judge I did not persuade him—at least so he said—but I think it's significant protection to the insurance fund. The holding company is not in a position to—

Senator SARBANES. Of course, the insurance fund is inadequate protection under any circumstance if depositor or investor confidence is lost.

Mr. BAKER. Yes, sir.

CONCERN AMONGST DEPOSITORS

Senator SARBANES. I'm hard put to see how, if the name or the involvement of a holding company is in jeopardy, that's not going to spark concern amongst the depositors, no matter how much you may try to reassure them about the deposit fund and about the supposed legal separation between the broader holding company and the depository institution.

I don't think it's a sufficient answer to address the legal separation without going beyond that to address whether, as a practical matter, you're going to be able somehow to get across to depositors and investors the fact that their confidence ought not to be affected, I am very hard put to see how you are going to succeed in doing that.

Mr. BAKER. I would not argue with you that if you had a general loss of confidence in a holding company that that could translate to a loss of confidence in the flagship bank. There's no question about that. They would have, as they normally do, the same name. But that situation will exist even if you didn't have the holding company, if you start with the assumption that there would be situations where a loss of confidence would occur.

Senator SARBANES. Well, except that the activities of the holding company are more likely to lead to the loss of confidence than perhaps the more limited activities of the flagship depository institution.

Well, my time has expired. Thank you very much, Mr. Secretary.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Let me welcome you, Mr. Secretary. I'm an admirer of yours, as you know, and I wish you well in your term in this office.

In the past, your predecessor, former Treasury Secretary Regan, testified before this committee that he believes banks somewhere down the line ought to be able to underwrite corporate securities and he's quite direct about answering that when it was put to him. Do you share that view?

Mr. BAKER. He was in a different business than I was in. [Laughter.]

Senator RIEGLE. I realize that, but do you share his view or do you have a different view?

Mr. BAKER. I have a little different view, Senator Riegle. I don't think that's a step that we ought to take now for the reasons that I have suggested in answer to prior questions.

Senator RIEGLE. Let me just stop you there because I want to cover a lot of ground and I know you're in a hurry too. I know you don't want to do it now and I think that's quite clear. I'm talking about in terms of the set of steps over a period of time.

Mr. BAKER. Well, that would really be a repeal of Glass-Steagall in its entirety and, as I suggested earlier, I think we ought to take a look at some selected exceptions and see what the experience is before we move that far.

Senator RIEGLE. You're not then prepared to say categorically today that you're ruling out that possibility in the future?

Mr. BAKER. I certainly would not. I would suggest that it would be far more prudent to take a look at what some selected exceptions would do with respect to the various industries.

Senator RIEGLE. Well, I think that's a very critical distinction because I think once you start down this road, once you give this snowball a push over the top of the hill and it starts going downhill, I'm not sure you're going to have the luxury somewhere in the middle of the hill to say let's stop this snowball from rolling and take a look and see where we are. I have a feeling that once you get it going, that that distinction that you've just made may not be plausibly available to you or anybody else and that we would end up at the bottom of the hill with banks underwriting corporate securities.

Would it trouble you if you thought today that that would be the end result?

COULD RESULT IN A MERGER OF TWO INDUSTRIES

Mr. BAKER. Well, I really don't know. I think it would certainly result in a merger of those two industries. I mean, you would end up having the banking industry and the securities industry all in one pot.

The CHAIRMAN. If I could interrupt without taking away from the Senator's time, Don, you and I have worked together for a long time. I don't think we can describe the process as a snowball. After 10 years of me trying to maybe start some kind of a snowball, I don't really think you have to worry about a snowball. And if it helps any, I am not in favor of going that far. I don't think that the limited steps we're talking about now will lead to that kind of dismantling of Glass-Steagall any time that I'm in the U.S. Senate. I think it's a hypothetical situation of what happens in an evolving process over a couple of decades. Maybe that will eventually occur, but I don't think anybody that I know of is advocating going anyplace close to that with Glass-Steagall at this time, and I want to assure you that I certainly am not.

Senator RIEGLE. Well, I appreciate the chairman's comments, but those were the sentiments of the predecessor of the current Secretary of the Treasury and he was quite plain spoken about it and so that's why I think it's important to nail it down.

Let me raise a related question. I think Senator Sarbanes did a good job of examining the question of safety, soundness, and the confidence and how you seal these things off.

I am concerned about the possibility of tying relationships, especially if we're going to see banks in the securities business in one form or another, in the insurance business, or in the real estate business. It seems to me that the credit function in this country which is profoundly the province of banks is such a powerful activity with the ability to make or break commercial enterprises, that the danger of tying relationships becomes very real. You are well aware of this because you were out there as a private sector player and needed to find bank financing. Therefore, do you have any concern at all about the possibility that someone who's seeking a line of credit from a bank for a business venture might feel that they really were under an unspoken obligation to go next door to the

bank's affiliate to handle their real estate and insurance and corporate securities needs in order to make sure that they were kept at the front of the line at the credit window?

Mr. BAKER. I really don't worry about that, Senator Riegle, in light of the language that, as I understand, you had in the earlier Garn bill which prevents those tying arrangements. So I would not think that that would be a problem if it's properly addressed. I think unaddressed it would be.

Senator RIEGLE. Well, I'm concerned about the degree to which this is taken into consideration. As you know, we've just had—and you're involved right now in some situations where very express laws that prevent the laundering of cash were violated by major banks in this country. We have just had a major brokerage house with a high reputation involved in behavior that is illegal and improper and there's been action taken against it. When you've got that pattern of leakage of even reputable institutions when there's the opportunity, and a situation has been created that seems to invite the practice of abuse, to say that somehow or another that just won't happen or it's unlikely to happen, in light of what we're seeing today, I think you're more realistic than that. I know I am, and I'm a little troubled about it because I'm not sure we have addressed the tying question sufficiently.

Mr. BAKER. Well, I'm not an expert on the specific language that you had in the bill, but what I mean to say is not that situations like that might not occur and not that there might not be some potential for abuse. We are all aware of that. I agree with you that the potential would be there. But we need to address it. It seems to me that you are seeking to address it in this bill. We support addressing it.

Senator RIEGLE. Let me ask you this.

Mr. BAKER. Excuse me, but it would be no different, would it not, than the provisions that now exist in the law with respect to loans by banks to directors and that sort of thing. That's covered by regulation or law, and we police that and hopefully do a reasonable job of it.

Senator RIEGLE. Well, except the magnitude of the danger here, it seems to me, is far larger. It's a systemic danger that I think we may create for ourselves if we go through an industrywide restructuring. If a given bank violates the law, that bank may get into trouble, but I am concerned about the strength of the overall financial system so let me pose a couple questions along that line.

When the Comptroller of the Currency testified here last year on Continental Illinois, he indicated that our Government would not allow any of the 11 largest banks in the United States to fail. Is that the current administration policy?

Mr. BAKER. Well, there's no administration policy to assist or not assist banks on the basis of size alone. That's not our policy. The question of whether or not there would be a systemic effect on the banking system of the failure of a particular bank or bank holding company is something obviously we would have to address, but we would have to look at each particular case on its merits.

Senator RIEGLE. You see, that's the problem that we're running into where there is no fixed yardstick. There's sort of an elastic yardstick. It was applied one way in Continental Illinois. A number

of other banks in the country, in fact the largest number in many, many years last year went out of business, a greater number are going to go out of business this year, and an entirely different approach is taken.

FOREIGN INVESTMENTS BY NINE LARGEST BANKS

And the concern that I have is that it relates to the overall strength and structure of the financial system. When we learn, for example, that the nine largest banks in the United States have over 100 percent of their net worth invested in foreign loans to just four countries—Argentina, Mexico, Brazil, and Venezuela—that's unnerving to me. And if I were to imagine going through the whole set of steps in terms of financial deregulation, that we would have to implement so that we could get to a handful of national banking institutions across the country some number of years down the road, I would be concerned about people seeking loans, Americans seeking loans in banks out across the country, whether in Michigan, or in Texas, or wherever. I would be concerned that these people may find that they may put their money in that bank but their money may be getting loaned abroad for a premium return—on that kind of a loan—even though it may not be a very safe loan, and that the average citizen isn't able to get a loan. I am concerned about those trendlines and you can't say they're not there because the data today shows they're there. When the nine largest banks have over 100 percent of their net worth invested abroad in four rather shaky financial situations, doesn't that give you some concern?

Mr. BAKER. Oh, sure, but it seems to me, Senator, that there's great pressure to produce profits in this free enterprise system of ours and there's pressure in the banking industry as well as in other industries.

To the extent that we expand, it seems to me, the opportunities and the powers and the areas consistent with safety and soundness, we will be strengthening the banks, not weakening them. They won't have to look—I mean, you understand the grammatic way in which I'm saying this—they would not then have to say, "OK, if we're going to make our 15 percent return on whatever it is we've got to make sure that we have a fine portfolio of loans here," and maybe there wouldn't be as many loans of the nature you describe.

Senator RIEGLE. It sounds to me, if you extend that logic, that those loans to the four foreign countries are the more profitable ones and that's why they were made—they certainly weren't made on the quality of the loan, they were made on the profit—they could follow what you just said and double the size of those loans today. They could go out and double their bets in those countries that's what I don't want them to do.

What I mean to say is, I think you've got a problem in the banking system that goes far deeper than our discussion today has dealt with.

Let me ask you this. According to newspaper accounts, earlier this week the central banks warned the Bank for International Settlements—and I'm sure you saw the articles because they appeared in the national financial journals—that governments around the

world should take a more cautious approach to financial deregulation. They warned that the fast-changing structure of modern markets make it harder to control inflation and could lead to instability and premature recession. And I was really struck by that. I'll just hold up the article. This is out of the New York Times and the headline is "Central Bankers Deregulation Warning." Because this seems to be a composite of worldwide opinion saying that there's enough stress now on the financial system with a lot of banks in difficulty, the savings and loan industry in difficulty in this country, that it's time to go slow in the deregulation area, but it seems to me you're taking exactly the opposite view and I'm wondering how is it there is such a sharp difference of opinion here in terms of what we're hearing from others?

Mr. BAKER. Well, because I think we think the reasonable steps we're suggesting will alleviate that stress on the system. It will in effect provide for a more sound system because it will provide for a more competitive and profitable system.

These activities, Senator Riegle, that we are suggesting are all incidental to activities that banks are now undertaking. We are not, in our view at least, suggesting something that is inherently risky or that would impact the banks adversely from a safety and soundness standpoint. We think it will strengthen the system.

The CHAIRMAN. Senator Riegle, I've just got to turn to Senator Sasser. Your time is up and because of the joint session he won't get his turn. Senator Sasser.

Senator SASSER. Thank you very much, Mr. Chairman.

Mr. Secretary, in previous testimony before this committee, we've heard that the number of problem banks is at an all-time high and I think you can tell from Senator Riegle's line of questioning that there is some concern on the part of some of us on the committee about that matter.

The number of problem banks stands at 949 and from all predictions that we hear, the number of bank failures will exceed last year's post-depression record of 79. Of course, the problem of S&L's appears to be increasing and has been dominating the business pages now for a number of months.

And I'm picking up signals that now certain aspects of the insurance industry may be under some strain.

What, in your opinion, are the causes of these strains that we're seeing in our financial structure, particularly in our financial services sector, and what can be done to alleviate them?

Mr. BAKER. Let me just say that the failure rate for banks in 1985 is comparable to the rate in 1984, it is not greater than the rate in 1984. But I think the cause is primarily imprudent lending practices. As I indicated in response to an earlier question, I think the cause is basically a lot of people banking on continued high inflation, particularly in the area of energy loans and agricultural loans. And I think if you look at those banks that are on the problem list you would find a vast majority of those banks have problems as a result of lending in those two areas.

Senator SASSER. Well, Mr. Secretary, I can't take a lot of comfort from the fact that the bank failure rate this year probably, according to your testimony, will not exceed last year's because, as you

know, last year we had the highest record of bank failures since the depression years.

What can you tell us about the overall health of our financial services industry today?

Mr. BAKER. I think the overall health of the banking industry is quite good, Senator. I don't see that the failures you have suggested or the number of problem banks on the regulators' list of problem banks are indicative of any widespread structural problems that should raise concerns about the overall safety and soundness of our banking system.

Obviously, it's no secret that thrifts continue to be in a fragile transition period. I think that we are encouraged, however, with respect to the earnings trend for thrifts. It's up as a result of interest rates coming down. So we are optimistic with respect to thrifts.

Regarding the financial services industry overall, as you mentioned in your question, I don't think there is any cause for undue concern and I would reject any suggestion that we are in the midst of some sort of a major systemic problem with respect to any element of our financial services industry.

Senator SASSER. So, Mr. Secretary, can you provide us with some assurances today that we're not going to be hit in the near term with another shock like Continental Illinois, or Penn Square, or another failure in the financial services industry?

Mr. BAKER. I certainly can't provide you with any assurance that there might not be another bank failure.

Senator SASSER. I'm talking about a big bank failure. That's what's got us worried.

NO CAUSE FOR UNDUE ALARM

Mr. BAKER. Well, that's a question more properly addressed, I suppose, to the Comptroller of the Currency or the Chairman of the FDIC, but let me just say this, Senator Sasser, I don't see any cause for undue alarm at all.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Secretary, we appreciate your willingness to be here and the directness of your answers. You are extremely well informed for being in your position for such a short period of time. I'm sorry we do have to end early because of our respect for the Prime Minister of India, but we'll look forward to having you before the committee again in the near future. Thank you very much.

Mr. BAKER. Thank you, Mr. Chairman.

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 10:35 a.m. the hearing was adjourned.]

[Letter to Secretary Baker with written questions from Senator Proxmire and Secretary Baker's response to questions of Senator Proxmire follow:]

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United States Senate
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, DC 20510

June 17, 1985

The Honorable James Baker
Secretary of the Treasury
Department of the Treasury
Washington, DC 20220

Dear Mr. Secretary:

During your June 13 appearance before the Banking Committee I had intended to seek your views on the international debt problem in general, and in particular recent events related to the situation in Argentina. Since the hearing was cut short for a Joint Session of the Congress, I was not able to do that.

Late last year we received assurances from many bankers that the international debt genie was back in the bottle, and the problem was behind us. I was skeptical about those statements and in late December wrote to Senator Heinz, Chairman of our International Finance and Monetary Policy Subcommittee, indicating my strong interest in oversight hearings on the international debt situation and how the bank regulatory agencies are implementing the authorities given them by Congress in the International Lending Supervision Act of 1983. He has given me a commitment to convene such hearings, hopefully this summer.

Since you have a major role in determining United States policy with regard to these international debt problems, and because they are so closely related to other banking matters before our Committee in which you have expressed interest, including new bank powers and deposit insurance reform, I want to let you know of some of my concerns. At least a few major banks, I know, are complaining to the regulators that increased capital requirements are making it more difficult for them to maintain the flow of funds needed by debtor nations. Informed observers, on the other hand, say capital requirements for the big banks are still much too low in light of their international exposure. Developments since December in Brazil, Argentina and some other countries, where these banks have large outstanding loans, confirm the need to press forward with significantly raising the capital requirements of our banks - and I hope you and the other regulators will do so.

As noted above, I am aware of the latest effort by Argentina and the IMF to agree on a new economic program that will enable that country to reform its economy and continue to service its international debt. As part of that program I understand the

United States and other nations will make a $480 million bridge loan to Argentina, of which the U.S. share will be $150 million. Why is our government putting up this money? Doesn't Argentina have sufficient foreign exchange and/or gold holdings to meet its current interest obligations without such a bridge loan? Also since the $150 million is not being appropriated by Congress I would like to know under what authority you are acting, how long this money will be at risk, and whether there is any chance it will not be repaid.

I further understand that the West German government has decided not to participate in this bridge loan. Is this because that government has followed a policy of having its banks gradually write down a lot more of their international debt, and thus has less need to be concerned with the effects of the debt problem on West German banks? Should not our regulators either require our banks to decrease the book value of some questionable foreign assets or at least hold additional reserves against them?

Two key points of the Administration's five-point strategy for dealing with the debt crises require our country to sustain a strong, long-term economic growth, and a continued willingness to absorb a vastly enlarged flow of imports from the debtor nations. In view of the inability of this Administration and the Congress to adequately deal with the budget deficit, and the deleterious impact that is having on both our economy and trade balance, I am concerned whether the present strategy is really viable.

For example, Budget Director Stockman recently announced a lower economic growth forecast compared to the Administration's previous projections. If the new Stockman forecast is correct, what effect will these lower U.S. growth rates have on the Administration's international debt strategy? How sensitive is the Argentine debt problem to alternative growth rates in the U.S. and world economy? What will happen to Mexico's ability to service its debt if our economic growth slows and international oil prices continue to decline? Will Brazil be able to service its debt if the U.S. insists on a more equitable balance of trade with that country?

I look forward to your early written response to these questions and to seeing you at a hearing in the near future at which we can discuss these important issues further.

Sincerely,

William Proxmire, U.S.S.

THE SECRETARY OF THE TREASURY

WASHINGTON

July 17, 1985

Dear Senator Proxmire:

Thank you for your letter of June 17, in which you express concern about the ultimate success of our debt strategy and the implications of the international debt problem for U.S. banks. Fortunately, a good beginning in restoring the creditworthiness of troubled debtor nations has been made but the process will take time. A number of these countries which are making difficult adjustment efforts have started to grow again while meeting their debt obligations. However, although the general situation continues to improve, we will continue to be faced with individual country problems from time to time. Unrelenting efforts by developed and developing countries, commercial banks, and the international financial institutions will be necessary to ensure that the objectives we all share will be achieved.

As you point out in your letter, two key elements in the debt strategy are the special responsibility of the industrial countries - sustained non-inflationary growth and open markets to provide the debtor countries with export opportunities. The Administration has been active in ensuring the success of these elements. In particular, it is seeking prompt Congressional action to reduce the Federal deficit which could provide the environment for a further lowering of interest rates, and growth would be furthered by implementing the President's tax reform proposals.

We have discussed the need for sustained growth and higher employment with other nations on a number of recent occasions, such as the Bonn Economic Summit, the OECD Ministerial meeting, and the meetings of the IMF-IBRD Interim and Development Committees. In these discussions, I have stressed that as growth in the United States inevitably slows from the high 1984 rate, to a more sustainable level, economic policies and developments in Europe and Japan, in particular, will become increasingly important. I have also pointed out that the imports by European countries and Japan from developing countries will have to increase significantly; last year the United States accounted for well over one-half of the improvement in the trade balance of the non-OPEC LDCs. In addition, by pressing for a new round of trade negotiations we hope to benefit exports from developing countries.

We are very much concerned about the sensitivity of the debt servicing abilities of heavily indebted countries like Brazil, Argentina, and Mexico to variations in the rate of growth of the U.S. economy and commodity prices. It is our conclusion

that slower growth in the United States would lead to lower export growth rates from such countries, but working in the opposite direction would be the benefit of lower interest payments from the sharp reduction in U.S. interest over the past year. For Brazil, Argentina, and Mexico changes in interest rates have a major impact on contractual debt servicing payments. As a rough rule of thumb, we estimate that working in the opposite direction, a one percentage point drop in dollar interest rates would result in savings due to lower interest payments far exceeding the slower growth in exports to the United States which would result from a one percent slower U.S. growth rate. This rule of thumb would not be as favorable, however, for countries relatively less heavily burdened with debts to foreign banks.

With regard to the impact of possible declines in oil and other commodity prices, our analysis is that any precipitous drop would create serious difficulties for those debtors heavily dependent on these commodity exports but would, in the case of oil, benefit other debtors who are net importers. Among the more important debtors only a few are dependent mainly on a single commodity or oil. Most export a variety of raw materials, foodstuffs, and manufactured products. The continuing growth in the volume of these exports would partly offset a fall in prices.

The multilateral bridge financing totalling up to $483 million is a clear demonstration of international support for Argentina's courageous new economic program and its democracy. This Argentine program has recently been agreed with the management of the International Monetary Fund (IMF) and is being submitted to the IMF Executive Board for formal approval by mid-August. Under the program, Argentina is expected to qualify for IMF balance-of-payments financing, the first two tranches of which are expected to be used by Argentina to complete repayment of the multilateral bridge financing by September 30, 1985.

This short-term financing for Argentina is similar to ESF financing provided over the last three years in support of the efforts of such countries as Brazil, Mexico and the Philippines to undertake IMF-approved economic adjustment programs. Financing on a case-by-case basis "bridged" to IMF drawings is another of the basic elements of the Administration's strategy for dealing with the problems of international indebtedness. All such past financing, which is provided pursuant to the authority of the Secretary of the Treasury over the ESF under the Gold Reserve Act of 1934, as amended (31 U.S.C. 5302), has been repaid.

In determining whether to provide financing to Argentina of up to $150 million, we have applied the same general criteria as for earlier ESF bridge financings, including a demonstrated need for short-term liquidity and close cooperation with the IMF on an economic adjustment program. At present, Argentina's liquid international reserves are at a very low level due to

large external payments over recent months and a virtual cut-off of medium-term credits from foreign commercial banks. Although Argentina's official gold holdings remain substantial -- 4.4 million troy ounces in April with a current market value of $1.4 billion, we understand that for political reasons the government feels it cannot sell this gold at this time.

As with other ESF financing, some risk is involved. We believe, however, that the risks have been minimized and that there are reasonable assurances of repayment in the short-run, given the agreement between Argentina and the International Monetary Fund. The risks are also being shared with the monetary authorities of eleven other countries - Austria, Belgium, Brazil, Canada, Denmark, France, Italy, Japan, Mexico, Spain and Venezuela - through the provision of the financing under a multilateral arrangement.

As you note, Germany chose not to participate in the multilateral financing. According to press reports, a spokesman for the Bundesbank said that the Bundesbank was not legally empowered to extend uninsured credits and that in its judgement Argentina's situation did not constitute a danger threatening the collapse of the international financial and currency system. So far as we know, the effects of bank regulatory procedures were not a factor in the Bundesbank's decision.

In the United States, there are established procedures for bank examiners to appraise the soundness of banks' loan portfolios and the adequacy of loan loss provisions against potential losses. Following enactment of the International Lending Supervision Act of 1983, the Federal banking regulatory agencies implemented a number of changes to strengthen these procedures, including the introduction of "Allocated Transfer Risk Reserves" when specified loans to a country are judged to be "value impaired." The amount of loan loss reserves has increased substantially in reaction to problems in servicing international loans and, in general, U.S. banks have strengthened their capital base. Regulatory agencies are paying considerably more attention to these factors.

I hope this answers your questions on these important issues.

Sincerely,

James A. Baker, III

The Honorable William Proxmire
United States Senate
Washington, D.C. 20510

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

PART II

TUESDAY, JUNE 18, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Gorton, Mattingly, Proxmire, Cranston, Riegle, Dodd, Dixon, and Sasser.

OPENING REMARKS OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

This morning we are continuing our series of hearings on oversight of the financial services industry. We do have three separate panels this morning composed of Mr. Edwin B. Brooks, president of Security Federal Savings & Loan of Richmond, VA; Kenneth Albers, chairman, Provident Savings Bank, Jersey City, NJ; Betty Tom Chu, president, Monterey Park Savings Bank, Monterey Park, CA. The second panel will be Mr. Kent Colton, executive vice president of the National Association of Home Builders; and Robert J. Spiller, chairman and chief executive officer of Boston Five Cents Savings Bank of Boston, MA. The third panel will be Robert A. Hess, manager, Wright-Patman Congressional Federal Credit Union, Washington, DC; and Joseph Perkowski, manager and treasurer of Minneapolis Federal Employees Credit Union, Minneapolis, MN.

Senator Dixon was here earlier and not able to stay. He asked that his statement be inserted in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, we have a very distinguished group of witnesses before the committee this morning, and I look forward to hearing their testimony.

This is the seventh in a series of hearings on the problems and changes affecting the financial services industry. These hearings are in addition to the numerous hearings that were held in the last Congress on many of the same basic issues, and to the hearings held back in 1981 and 1982 on the same subject areas.

Even this very short summary of the committee's work demonstrates that there has been no attempt to act in a hasty manner without having a proper factual foundation. Indeed, the committee, in my view, has gone more than the last mile in an attempt to be fair to every party with an interest in financial services legislation.

The committee has the evidence; now is the time to act. We cannot afford further delay. Continuing to permit the future structure of the financial services industry to be determined by those most able to exploit the loopholes in current statute represents a bankruptcy of the legislative process. We need to address the issues before us and enact necessary reforms.

Last year's Senate bill, which passed by an overwhelming vote of 89 to 5, provides a reasonable basis for action this year. I am hopeful that this committee will report a bill soon that is along the lines of last year's bill, and that we will get quick action on the Senate floor and an early conference with the more limited bill that now seems to be moving in the House.

I look forward to continuing to work with this morning's witnesses and all interested parties in an effort to achieve prompt enactment of a bill that represents a reasonable answer to the problems facing the financial services industry today.

The CHAIRMAN. Gentlemen, we do have a lot of witnesses this morning.

So, Mr. Brooks, if you would like to begin.

STATEMENT OF EDWIN B. BROOKS, JR., PRESIDENT, SECURITY FEDERAL SAVINGS & LOAN, RICHMOND, VA, CHAIRMAN, LEGISLATIVE COMMITTEE, U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. BROOKS. Thank you, Mr. Chairman. My name is Edwin B. Brooks and I am president of Security Federal Savings & Loan Association, a thrift institution located in Richmond, VA. I welcome this opportunity to appear before this distinguished committee today on behalf of the U.S. League of Savings Institutions, of which I am currently legislative chairman.

To save time, Mr. Chairman, my oral remarks will touch only on the highlights of our written statement but I ask that the latter be included in the record.

The CHAIRMAN. It will be.

[The complete prepared statement follows:]

STATEMENT

OF THE

U. S. LEAGUE OF SAVINGS INSTITUTIONS

PRESENTED BY

EDWIN B. BROOKS, JR., PRESIDENT,

SECURITY FEDERAL SAVINGS AND LOAN ASSOCIATION,

RICHMOND, VIRGINIA

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

OF THE

UNITED STATES SENATE

Washington, D.C.

June 18, 1985

Mr. Chairman, my name is Edwin B. Brooks, Jr. and I am President of Security Federal Savings and Loan Association, a thrift institution located in Richmond, Virginia. I welcome the opportunity to appear before this distinguished Committee today on behalf of the U.S. League of Savings Institutions*, of which I currently am Legislative Chairman. My statement will cover a fairly broad range of topics of interest and importance to the savings institution industry, concentrating on such matters as the appropriate dividing line between banks and thrifts and the need for measures to improve the ability of the Federal Savings and Loan Insurance Corporation to meet the challenges confronting it, but touching on other items as well.

UNITARY S&L HOLDING COMPANIES UNDER CURRENT LAW

By providing broader investment powers to federal associations, particularly with regard to its provision of a 10%-of-assets investment basket for commercial loans, the

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*The U. S. League of Savings Institutions serves more than 3,500 member institutions which make up the $1.1 trillion savings association and savings bank businesses. League membership includes all types of institutions -- federal and state-chartered, stock and mutual. The principal officers include: John B. Zellars, Chairman, Atlanta, Georgia; Gerald J. Levy, Vice Chairman, Milwaukee, Wisconsin; William B. O'Connell, President, Chicago, Illinois; Philip Gasteyer, Executive Vice President and Director of Washington Operations; and James O. Freeman, Senior Vice President and Senior Legislative Representative. League headquarters are at 111 East Wacker Drive, Chicago, Illinois 60601. The Washington Office is located at 1709 New York Avenue, N.W., Washington, D.C. 20006. Telephone: (202) 637-8900.

Garn-St Germain Act raised the question of how to deal with the activities flexibility available to unitary savings and loan holding companies. As a concomitant of savings institutions' commitment to housing finance, unitaries, unlike bank holding companies, long had been subject to no activities restrictions. Because concerns over the separation of banking and commerce potentially were relevant to savings institutions enjoying, albeit to a limited degree, empowerments formerly restricted to commercial banks, Congress in the Act provided a test for determining when a thrift institution had abandoned its housing specialization to such a degree that its holding company should be under a regime of activities restrictions -- i.e., those to which multiple savings and loan holding companies are subject -- similar to those applicable to bank holding companies . The test selected was that found at section 7701(a)(19)(C) of the Internal Revenue Code, which requires savings institutions wishing to obtain any of the benefits of the favorable bad debt deduction found at section 593 of the IRC to maintain not less than 60% of their assets in so-called qualifying assets -- mostly residential mortgages and liquidity items.

U. S. LEAGUE SUPPORTS APPROPRIATE ASSET COMPOSITION TEST

The U.S. League continues to support the concept of an asset composition test as the most logical and equitable way to establish the regulatory boundary between savings institutions

(and their holding companies) and commercial banks. First, it is based on the eminently reasonable premise that the regulation of financial institutions should be based on their actual activities, rather than what they possibly could do under statutorily available options. Because the differences between savings institutions and commercial banks are based primarily upon investments, the make-up of a depository's assets provides a readily quantifiable measure of its location in the depository institutions continuum, and thus offers an excellent means for determining whether an institution should be subject to regulations suitable for entities devoted principally to commercial lending, or those covering depositories primarily concerned with residential real estate.

In this connection, we must emphasize that very substantial differences remain between the activities of the average commercial bank, primarily oriented toward commercial credit, and the typical thrift, dominantly focused on residential real estate. The onset of commercial lending authority for our business in 1982 in no sense resulted in financial institution homogenization. As of year-end 1984, commercial lending represented a mere 1% of our assets, while our involvement in mortgage finance remained at very high levels. In fact, savings institutions accounted for 54% of all residential mortgages made in 1984, up from 46% in 1983.

As we noted in our testimony before this distinguished Committee in February of 1984, the second reason the U.S. League supports the use of an appropriate asset composition test is quite simply that it would offer to each institution's board of directors and management the freedom to determine their future direction within our diverse and specialized financial system. Freedom to choose the system under which to live and work is the basis of our political system and is also the thrust of the deregulation effort of recent years.

COMPONENTS OF ASSET COMPOSITION TEST

In terms of the specific components of an asset composition test, the League believes that the test as a fundamental matter must be consistent with the Garn-St Germain Act objective of providing savings institutions with the investment flexibility they require to remain housing specialists in a deregulated funds-acquisition environment. Savings institutions that maintain their primarily housing-finance character should be allowed to maintain the holding company and other flexibility they traditionally have had as a counterweight to the earnings handicap associated with a residential real estate concentration.

NEED FOR INCREASED CREDIT FOR LIQUID ASSETS AND MORTGAGE BANKING ACTIVITIES

On balance, the U.S. League regarded the 60% housing-related assets test found in last year's S. 2851 as well-suited to the task of delineating the regulatory boundary between savings institutions and commercial banks -- subject to the making of several vital modifications. Most importantly, it is essential that any new test provide adequate credit for liquidity items and for mortgage loans that institutions originate for sale in the secondary market. S. 2851 counted toward the 60% test those liquid assets of the type required to be held under section 5A of the Federal Home Loan Bank Act, as well as 50% of the dollar amount of all residential mortgage loans originated and sold within 90 days; but these items together were subject to an aggregate 10%-of-assets cap within the context of the test. The League strongly urges the Committee to consider taking a more flexible position with regard both to liquidity and the so-called "mortgage-banking" credit.

Liquid assets basically are carried by savings institutions as items that may be disposed of quickly to meet day-to-day withdrawal or investment needs, and FHLBank members, pursuant to section 5A of the FHLBank Act, are required to maintain in liquid assets a minimum amount equal to 5% of their net withdrawable accounts. The current industry average is

approximately 12%-15%, however, with some institutions as high as 20% where local conditions demand. This high level of liquidity simply reflects the hard lessons learned in the difficult and unsettling economic conditions that have confronted our industry since 1981. It should also be noted that maintenance of higher liquidity levels has proven a necessity for many institutions in recent weeks, when they have prepared for unusual deposit withdrawal pressures following the adverse publicity surrounding the problems of privately-insured Ohio and Maryland savings institutions.

The impulse to cap liquid assets with respect to the 60% test appears to reflect a view that liquid assets essentially act as an alternative to investment in housing. On the contrary, maintenance of a healthy portion of an institutions' portfolio in liquid assets is a prudential step that is absolutely essential for an institution that wishes to survive as a housing lender in the more challenging marketplace that has emerged in the wake of interest rate decontrol.

We must stress that thrifts choosing liquid assets as a substitute for home lending would be embracing a strategy for bankruptcy. Depository institutions' cost structures, unlike those of mutual funds, are such that higher-yielding investments, such as mortgages, are needed if they are to stay in business.

Moreover, as we noted in our testimony of last February, any savings institution that attempted to restructure itself as a sort of investment company insured by the Federal Savings and Loan Insurance Corporation would run into substantial statutory obstacles. For example, section 5(a) of the Home Owners' Loan Act mandates that federal associations provide credit for homes and other goods and services in addition to serving as locations for the deposit or investment of funds. Furthermore, section 6(i) of the Federal Home Loan Bank Act makes membership contingent upon maintaining a management or home financing character consistent with sound and economical home financing, and section 403(c) of the National Housing Act likewise makes the existence of sound and economical home financing a touchstone for the granting of FSLIC insurance of accounts.

Despite this, we are sensitive to the concerns in this area, and suggest, as we did last year, that an appropriate means of alleviating them without interfering with operational flexibility would be to place a 25%-of-assets cap on the ability of institutions to credit liquid assets toward satisfaction of the test. This clearly would eliminate the possibility of investment-company-style behavior, while affording reasonable opportunity for savings institutions to comply with the purposes for which a qualified thrift lender test is designed.

It should be borne in mind, however, that circumstances, such as periodic declines in the housing market, may require high levels of liquidity over a period of time, and any liquidity cap -- indeed the entire 60% test itself -- thus should be made subject to an authority on the part of the Bank Board to take emergency conditions into account. The test must not be designed to punish housing specialists who temporarily are forced to divert from their specialty because of unfavorable market conditions.

Regarding the mortgage banking credit, we urge that it be unlinked from treatment of liquid assets, and allowed to count toward the 60% test up to a 10%-of-assets ceiling. We are aware that some critics of the credit have made the baffling assertion that a mortgage-banking-type institution is not using its own resources to support housing. This is simply incorrect. Such a lender elects to quickly sell the mortgages it makes in order to obtain funds to make new mortgages for resale. In so doing, it is using nobody's resources but its own, and is using them to support housing just as much as any lender that keeps its mortgages in portfolio. Such an organization certainly deserves to have its support for housing more fully acknowledged acknowledged with regard to the 60% test.

While some questions have been raised as to the possibility of double-counting in connection with the mortgage banking credit, this a spurious concern, given carefully crafted language. The credit should only be given for those mortgages originated and sold where the temporary warehousing period by the originating institution or its affiliate does not contain a calendar quarter end at which qualified/non-qualified status is judged. Unless a mortgage banking credit is given for such loans, the qualifying test could never detect their presence, since they come and go between the calculation points. No double counting would arise from this type of mortgage banking credit. Qualified loans originated by the institution or its affiliate destined for the secondary market but not yet sold at the time of calculation would also be counted correctly, i.e., once, since they would naturally be an automatically qualifying component of the balance sheet at the calculation point.

INCLUSION OF EDUCATION AND CHURCH LOANS APPROPRIATE

As we stated in our testimony last year, the U.S. League also would like to see education and church loans included as elements of the 60% test. These credits already are counted as qualifying assets for purposes of the tax code's section 7701(a)(19)(C) test. While it is true these investments are not made for the purpose of financing housing (except where a parish house or similar facility is part of a church structure financed, or to the extent an education loan covers room

expenses) they nonetheless have been viewed over the years as being sufficiently charged with a public purpose to merit contributing to the triggering of housing-related tax benefits, and we believe it would be appropriate to allow them to be used for the test in question as well.

NEED TO USE ASSET COMPOSITION TEST TO DETERMINE FHLBANK ADVANCES ELIGIBILITY

Under S. 2851, failure to meet the 60% qualified thrift lender test basically would have had consequences paralleling those mandated for institutions failing the asset composition test of the Garn-St Germain Act, except that S. 2851 also would have provided that failing the test would make an institution ineligible for FHLBank advances, except as authorized by the Bank Board. The League supported this advances linkage as an appropriate sanction for institutions that were straying too far from the housing support function that is the basic justification for the FHLBank system in the first place. In our view, the S. 2851 language on this point was well-crafted, being flexible enough to authorize the agency to prevent institutions failing the test from benefiting from long-term advances, without shutting them off from emergency FHLBank liquidity assistance or hobbling the ability of the Bank Board to cope with special circumstances.

U.S. LEAGUE OPPOSES USE OF TEST OUTSIDE HOLDING COMPANY AND ADVANCES CONTEXTS

The League would be skeptical, however, regarding attempts to apply the test in any wider context. In particular, we oppose strongly any effort to penalize thrifts that fail the test by eliminating portions of their investment authority, such as commercial lending power and state-granted empowerments not in conformity with the authorities available to federal associations. (H.R. 20, recently reported by the House Banking Committee, incorrectly applies the qualified thrift lender test to these purposes unrelated to the separation of banking and commerce or access to the specialized central credit facility -- the Federal Home Loan Bank System -- established to encourage long-term residential mortgage credit.)

In our view, the fundamental function of the test must be to preserve the separation of banking and commerce and to guard against inappropriate reliance on the FHLBank system by non-housing-specialists. It should not be used as a means of returning thrifts to the days preceding the Garn-St Germain Act when savings institutions had little leeway to diversify. As that Act recognized, savings institutions in today's more challenging and difficult economic environment must be able to exercise a reasonable degree of investment flexibility if they are to be able to continue as housing specialists.

Establishing a link between meeting the test and the availability of investment powers (outside the context of holding company activities) would be a retrograde move that, by eroding thrift profitability and the ability of savings institutions to attract capital, would tend ultimately to undermine the ability of those institutions to support housing.

NEED TO PHASE IN TEST FOR SAVINGS BANKS

As the League testified last year, we believe that traditional savings banks chartered prior to the Garn-St Germain Act should be given a reasonable period in which to phase-up to the required 60% level. Although committed to housing finance, their asset-mix has traditionally been somewhat more diversified than that of other thrifts. We believe the S. 2851 as passed by the Senate dealt with this in an intelligent way, as well as accommodating appropriately some savings banks' desire to be covered by the Bank Holding Company Act.

BANK BOARD AND U.S. LEAGUE SHARE CONCERN OVER FSLIC

The state of the Federal Savings and Loan Insurance Corporation, which has been under severe and continuous strain since 1981, is a source of great concern for the Federal Home Loan Bank Board, and the League realizes that the agency has

been keeping you well aware of the reasons therefor. This concern has been responsible for a wide variety of Bank Board regulatory, organizational and legislative initiatives designed to protect the insurance fund since this distinguished Committee and the Senate dealt with S. 2851 in the 99th Congress.

The U.S. League, which shares the Bank Board's sentiments regarding the FSLIC, generally has been very supportive of these initiatives. For example, the League has provided the agency with support for the regulations it has issued to (1) place restrictions on investments in service corporations, equity securities and equity interests in real estate (known as the "direct investments" rule); (2) tighten net worth requirements and limit deposit growth; (3) restrict the use of brokered funds; (4) require tighter accounting regarding acquisition, development and construction loans; (5) impose limits on the use of subordinated debt for net worth purposes;and (6) cut back on the availability of loan loss deferrals. We also have backed strongly the Bank Board's efforts to free the agency's examining function from personnel ceilings, unrealistic compensation limits, and other counterproductive constraints by delegating it to the FHLBanks.

These actions have been very important, but both the Bank Board and the U.S. League believes that further steps,

including various statutory changes, to protect and enhance the FSLIC are necessary. Although our positions on these steps differ in certain respects from those of the Bank Board, we generally continue to remain in harmony with the agency regarding appropriate responses to this important issue. At this point, I would like to describe for you our views on some of these additional steps, which include: (1) improvement of the FSLIC function through freeing the agency from constraints regarding the compensation, hiring and firing of personnel, and delegating as much of its functions as possible to the twelve regional FHLBanks; (2) maintenance of the separate status of the FSLIC vis a vis the FDIC; (3) enhancement of the Bank Board's statutory enforcement tools; (4) revision of the Bank Board's approach to supervision; (5) reliance on risk sensitive premiums; (6) extension both of the emergency acquisitions provisions contained in Title I of the Garn-St Germain Act and the Net Worth Certificate Act; (7) establishment of limitations on the powers of state-chartered, FSLIC-insured institutions; (8) use of industry expertise by the FSLIC in the management of problem assets and institutions; and (9) improvement of the FSLIC's position in receiverships.

NEED FOR RESTRUCTURING OF FSLIC

The U.S. League has taken the position that one of the most singularly important steps that must be taken to conserve FSLIC

resources and assure a properly functioning organization is the restructuring of the FSLIC itself. In brief, the League strongly supports the taking of whatever steps are necessary to enable the FSLIC to have a staff of the size and quality necessary to meet its enormously increased responsibilities. Because of various legal incidents of its current "plain vanilla" federal agency status, the FSLIC is unable to hire, fire and compensate its personnel on a competitive, businesslike basis. One way or another, we realize the expense of these steps would be borne by our industry. Nevertheless, we are convinced that the benefits that would result, in terms of preserving the corpus of the insurance fund, would make the action well worthwhile.

In our view, Congress already has provided for clear authority for such a step by the "delegation" amendment to 12 U.S.C. 1437(a) made by the Garn-St Germain Act. The Bank Board already has utilized this statute -- with our enthusiastic support -- to delegate, in effect, the examination function to the Federal Home Loan Banks. To accomplish a thorough-going restructuring of the entire FSLIC organization, however, it appears additional statutory authority may be required, such as that contained in the agency's proposed Insured Institutions Improvements Act of 1985, S. 759. In this regard, the League strongly supports the bill's efforts to clarify that the FSLIC, like the FDIC, is not required to

"apportion" or estimate its annual expenses, with OMB approval necessary for expenditures exceeding predicted levels. As a further matter, the League has determined to support the maximum feasible delegation of FSLIC functions to the FHLBanks, a step which the League believes would reduce Washington D.C.-based processing bottlenecks.

U.S. LEAGUE OPPOSES MERGER OF FSLIC AND FDIC

Another issue of great concern to the U.S. League is the possibility of a merger of the FDIC and FSLIC. For a variety of reasons, including the pro-consolidation statements of the Chairman of the FDIC, the merger issue has been under considerable discussion in financial circles in recent months.

The League opposes any attempt to remove the FSLIC from Bank Board jurisdiction and consolidate that insurer with the FDIC. Not only would such an action be unjustified from the standpoint of the FSLIC's financial condition, we are convinced that it would diminish the effectiveness of thrift regulation, and tend to erode our ability to maintain a system of specialized housing lenders.

With respect to effective regulation of the savings institution industry, we are convinced that having a single system that unites the chartering, insuring and

liquidity-providing functions has provided us with an excellent, highly-coordinated system of regulation and supervision that has functioned very, very capably and responsibly throughout a period of extreme stress. To disassemble this structure by dismantling the FSLIC would be a terrible mistake.

Not only would it be an error from the standpoint of regulation and supervision, it would mean that a substantial segment of the industry -- those institutions with state charters -- no longer would have a federal regulator that was institutionally sensitive to the importance of thrift institutions' specialized home finance mission. We are convinced that the ultimate result of a merger of the insurance funds would be an unravelling of the rest of the special federal regulatory structure designed to assure the continued existence of depository institutions committed to the provision of mortgage credit.

Furthermore, we would note that the Report of the Task Group on Regulation of Financial Services, chaired by Vice President Bush, examined this issue in great detail and likewise concluded in favor of an independent FSLIC.

U.S. LEAGUE SUPPORTS NEW ENFORCEMENT POWERS FOR BANK BOARD

In terms of protecting the FSLIC, the Bank Board is keenly interested in upgrading its arsenal of enforcement tools in order to enable it to deal more effectively with some of the problems generated by "high-flier" institutions. The League, after long and detailed deliberations, has agreed to support important statutory changes in this area.

TEMPORARY CEASE-AND-DESIST ORDERS

Of these increased powers, the U.S. League believes that enhanced temporary cease-and-desist order authority would be among the most useful. Under present law, a temporary C&D -- which is, in effect, an administrative injunction -- may be used only where a violation of law, rule or regulation or an unsafe or unsound practice exists that could cause insolvency or substantial dissipation of assets or earnings, seriously weaken the condition of the insured institution or seriously prejudice the interests of its insured members. An institution facing such an order may contest it in U.S. District Court within 10 days of issuance; otherwise, the order remains effective until the underlying issues are adjudicated administratively.

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The Bank Board, in its Insured Institutions Improvements Act, S. 759, is seeking to eliminate "substantial" and "seriously" as modifiers of the terms dissipation and weaken, respectively. The League has determined that we can support this, subject to several conditions. First, such orders should be in effect only for 60 days, after which the current standard would have to be met. We believe this would give the agency adequate time to deal with emergency situations with what amounts to the free hand available in the temporary order context, without substantially compromising the general principle that injunctive-style relief requires the meeting of very significant initial standards (e.g. irreparable injury).

Second, this extraordinary new authority would be subject to a 2-year sunset provision. This would provide Congress with an opportunity to assess, within a relatively short time frame, the manner in which the new authority had been exercised by the supervisory authorities.

Third, procedural safeguards should be implemented to ensure full review of relevant files by the Principal Supervisory Agent and the General Counsel, with the opportunity for an informal plea (absent emergency conditions) to the Bank Board members by the target prior to issuance of such an order, with access by the target to the staff memo requesting the

order. These safeguards are designed to underline the fact that the new temporary order is not something to be employed without the most serious review and consideration.

The League also has elected to support the Bank Board in its effort to obtain an additional temporary order that would allow the Bank Board to require cessation of any action the agency deemed appropriate if, because of incomplete or inaccurate records, the agency, after reasonable effort, was unable to determine an institution's financial condition. While we believe the above procedural safeguards should apply to record-keeping temporary orders as well, the League does not believe a sunset provision to be necessary, in light of the central and paramount importance of complete and accurate records to the supervision of our system of federally-insured depository institutions.

CEASE-AND-DESIST AUTHORITY

The Bank Board is also seeking to have persons filing (or required to file) a Change in Savings and Loan Control Act notice, and subsidiaries of service corporations added to the list of entities against which C&D orders (or temporary C&D orders) could be issued. In addition, orders could be issued against individuals who have resigned from a potential target

organization and against an insured institution (or related individuals or an affiliate) during the two-year period after termination of insured institution status during which an institution still has insured accounts. The U.S. League has no objection to these proposals, provided the ability to obtain C&D orders against individuals who have resigned lasts only for two years after resignation. We believe this would represent a reasonable statute of limitations.

REMOVAL/PROHIBITION AUTHORITY

In addition to proposing increased temporary and standard cease-and-desist order authority, the Bank Board has requested greater removal and prohibition power, as well.

At present, removal/prohibition actions may be mounted against any officer or director of an insured institution, its service corporation or its holding company (or any subsidiary thereof) where, inter alia:

(1) there was (a)(i) a violation of a law, rule, regulation or cease-and-desist order which has become final;

(ii) an unsafe or unsound practice; or

(iii) a breach of fiduciary duty; and as a result,

(b)(i) the organization has suffered, or probably will suffer, substantial financial loss or other damage;

(ii) the interests of its insured members could be seriously prejudiced; or

(iii) the individual has received financial gain as a result of his conduct; and

(c) the conduct involved personal dishonesty, or has demonstrated or a willful or continuing disregard for the safety or soundness of the organization; or

(2) there was (a) conduct with respect to another business organization that resulted in substantial financial loss or other damage; and

(b) the conduct involved personal dishonesty or a willful or continuing disregard for the safety and soundness of the institution; and

(c) there is evidence of the individual's unfitness to continue as an officer or director.

Under the Bank Board's proposal, the "substantial" and "seriously" modifiers would be dropped from #1(b) and #2(a), breach of "professional duty" would be added to and equated with breach of fiduciary duty in #1(a), and receipt of financial gain would be added in #2(a) as the equivalent of loss to the employer. In addition, removal/prohibition actions could be taken against any person against whom a cease-and-desist order could be issued (subject, of course, to different criteria) and during the same period of time.

The League must decline to support the Bank Board's proposed elimination of "substantial" and "seriously" as modifiers, respectively, of the financial loss or prejudice to insured members' criteria, or its desired equation of breach of professional duty with breach of fiduciary duty as a removal criterion. The current removal standards generally seem suited to the seriousness of the penalty, and the League believes the weakening of those standards envisioned by the Bank Board would be inappropriate. In addition, we believe the concept of breach of professional duty is far too ambiguous for employment in the removal/prohibition context. The League supports,

however, the Bank Board's proposed expansion of the list of potential removal/prohibition order targets, as well as the equation sought by the agency of receipt of financial gain with loss to the employer.

AUTHORITY TO SEEK INJUNCTIONS

At present the Bank Board basically is required to seek correction of unsafe or unsound practices or violations of law or regulation through a procedure that permits recourse to the courts only upon appeal from the agency's final administrative adjudication of the matter. As part of its enforcement proposal, however, the Bank Board is seeking authority to go into U.S. District Court to obtain injunctions against such violations of unsafe or unsound practices when it determines that its administrative enforcement provisions are insufficient to resolve adequately the situation.

The League understands the Bank Board's desire to have a broad variety of rapid-acting enforcement tools, but we cannot support granting the agency a direct judicial injunction option. We believe the adverse publicity that necessarily would be associated with public court battles over Bank Board requests for equitable relief inevitably would be damaging to public confidence, not just in the target institution, but in

other associations as well. Moreover, given the substantial increment of temporary C&D power -- which essentially is injunctive power -- that the Bank Board is seeking and that the U.S. League is willing to support, we fail to see any real need for placing this additional tool at the Bank Board's disposal.

CHANGES IN CONTROL

In our view, one of the key aspects of the Bank Board's request for additional enforcement authority is its inclusion of provisions designed to give the agency more power to scrutinize changes in control. Essentially, the Bank Board is asking for enhancement of its definitional power regarding key terms -- such as "control" and "acting in concert" -- used in the Savings and Loan Holding Company Amendments of 1967 and the Change in Savings and Loan Control Act. The League strongly supports the Bank Board's efforts to gain more authority to pass upon the suitability of those persons and organizations wishing to acquire control of FSLIC-insured institutions.

UNSAFE OR UNSOUND PRACTICES

Another component of the Bank Board's enforcement package that the League supports involves a codification of the definition of the term unsafe or unsound practices. Such

practices, currently statutorily undefined, would be defined as encompassing "any action or omission which is, in the opinion of the [FSLIC], contrary to generally accepted standards of prudent operation, whether relating to the association's internal management or to any external matter, the possible consequences of which, if continued, may pose abnormal risk of loss or damage to an insured institution or any subsidiary thereof, to its stockholders or accountholders or to the [FSLIC]."

Basically, this would incorporate into the statute, with some modification, explanatory language from a 1966 memorandum from then Bank Board Chairman John Horne to Congress regarding the meaning of the term unsafe or unsound practices. This memorandum is part of the legislative history of the Financial Institutions Supervisory Act of 1966, and at present represents the most authoritative definition of that term. Although, as noted, the League supports this definition, we urge that the legislative history of the proposed codification include language clearly indicating that, regarding external matters, it is not Congress' intent to have prudent managers classified as committing unsafe or unsound practices when they are victimized by conditions beyond their control, such as high interest rates.

INVESTIGATIVE AUTHORITY

A further feature of the Bank Board enforcement package that the U.S. League can support is its improvement of investigative authority. S. 759 would provide that entities that no longer have FSLIC insurance or that no longer are affiliated with FSLIC-insured organizations could be investigated by the Bank Board with regard to conduct that occurred when they were so insured or affiliated. This strikes us as a reasonable increment of authority that would help the agency better carry out its enforcement responsibilities.

SUBPOENA ENFORCEMENT

A final enforcement tool the League endorses involves the consequences of failure to obey a Bank Board subpoena. Under S. 759, failure, without just cause, to comply with a Bank Board subpoena would be made a misdemeanor punishable, upon conviction, by a fine of not more than $1,000 and/or imprisonment for a term of not more than one year. Again, we believe this is a reasonable provision that materially would assist the Bank Board in its enforcement efforts.

NEED FOR REVISED FHLBB APPROACH TO SUPERVISION

The availability of these major new enforcement tools, as

well as the personnel enhancement capabilities inherent in the Bank Board's impending and proposed changes relating, respectively, to the examining and FSLIC functions, raise the possibility of a new and improved approach to supervision by the agency. This approach would involve focusing intense supervisory efforts on the activities of the kinds of high-flier institutions that pose the greatest potential threat to the FSLIC. (We must emphasize that we envision this by no means as reducing the Bank Board's overall supervisory efforts regarding other institutions.) The League has suggested to the agency that this should involve development and use of highly qualified teams of examiners, lawyers and financial experts that would be able to come to grips with complicated problems with maximum speed and skill. As an additional matter, we have urged that special detailed reports should be required when riskier activities are embarked upon, and on a monthly basis thereafter. We believe that, over time, such a revised approach to supervision could reduce the need for broad-brush, lowest-common-denominator-type regulatory efforts.

U.S. LEAGUE SUPPORTS LIMITED, EXPERIMENTAL VARIABLE RISK PREMIUM PROGRAM

Both the Bank Board and the FDIC have indicated their support for variable risk federal deposit insurance, with the

former agency proposing that it should be able to assess additional premiums against institutions engaging in activities of a nature or to an extent not permitted for federal associations.

The League has been reviewing the question of variable premium insurance in considerable detail. Without gainsaying the theoretical appeal of the concept, it is clear that many very complicated questions of implementation remain regardless of the approach one favors. What is risky? Who makes that determination and on what criteria? How much more must be charged to defray the risk? These are difficult questions to answer.

While the League at this time is reluctant to support a full-scale, open-ended authorization of variable premiums, we are willing to support a limited, experimental program that would apply supplemental premiums to real estate development and non-financial activities, and which would be subject to a two-year sunset provision. Recent regulatory initiatives, including the FHLBB's direct investment rule and new accounting restrictions on acquisition, development and construction loans may assist substantially in reducing the exposure of the FSLIC fund; therefore we recommend a "sunset" on this experimental grant of variable-risk premium authority. We also believe that

the FSLIC, in developing a premium structure, should be required to tie that structure to an analysis of what activities have caused it the most losses. Furthermore, the League feels that the experimental premium framework should be coordinated with a system of variable net worth standards that would apply to the same narrow band of activities covered by risk-based insurance. This would assure that at least a portion of the price exacted from an institution for engaging in riskier activities would not have to be expensed (thus impairing earnings and capital-rebuilding so essential to the future health of our business and the fortunes of the FSLIC).

In our view, an experimental program of this kind, integrated with a variable net worth requirement, would provide some necessary, and currently nonexistent, hard information about the functioning of variable insurance, enabling Congress in the end to decide whether proponents of such insurance are urging a practical solution to FDIC and FSLIC problems, or one for which the required regulatory engineering simply cannot be fashioned.

U. S. LEAGUE SUPPORTS EXTENSION OF BANK BOARD EMERGENCY ACQUISITION AUTHORITY

From the standpoint of protecting the FSLIC, some of the most useful provisions on the books are those found in Title I

of the Garn-St Germain Act (most especially section 123) which, inter alia, allow the Bank Board, as a means of preserving FSLIC's resources, to authorize virtually any kind of acquisition of a failing savings institution. These provisions are scheduled to expire on October 15, 1985, however.

The League strongly urges the Congress to extend the life of these provisions for another three years. They have saved the FSLIC a great deal of money, and, given the likelihood that the insurance fund will remain under considerable pressure for several years as institutions severely damaged in the 1981-82 interest-rate crisis struggle to regain financial health, promise to be a source of such savings in the future as well.

We would oppose, however, substantive changes in the emergency acquisitions statutes of the sort contained in the Federal Savings and Loan Insurance Corporation Protection Act, S. 1167. That bill would strike the requirements that: (1) the Bank Board, in considering such emergency authorizations, must give consideration to the maintenance of specialized depository institutions; and, (2) the agency, in authorizing those transactions, must do so pursuant to a bidding and priority framework basically designed to give first preference to savings institutions from the same state (and to minority institutions with respect to acquisition of minority institutions).

While the statutory framework admittedly would be somewhat easier to work with in the absence of the provisions sought to be deleted, we seriously doubt that it fairly can be blamed for causing FSLIC any excess costs with respect to assisted mergers. We must emphasize that the goals of ensuring continuation of depository specialization and local control are important ones that should continue to be linked to the emergency acquisitions authority. To reiterate, the League will resist strongly any attempt to delete these public-policy protections.

NEED TO EXTEND NET WORTH CERTIFICATE PROGRAM

As you are aware, the Net Worth Certificate Act, like the emergency acquisition provisions, is scheduled to expire October 15, 1985. The Act authorizes the Bank Board to provide a program of financial assistance for well-managed, low-net-worth institutions that are suffering operating losses.

Mr. Chairman, the League is very grateful for the support you gave us last year in providing in S. 2851 for an extension of the Act, and we hope that you and your colleagues will continue to work with us to assure that the program's benefits are not lost. We believe a three-year extension would be appropriate.

In our view, a primary virtue of net worth certificates is that they improve the ability of the Bank Board to let well-managed victims of the low-yield mortgage trap work their way out of their negative spread problems, with ultimate repayment of assistance once portfolio drag is sufficiently diluted through restructuring. This allows avoidance of the disruptions and increased financial concentration, and, potentially, some of the expense, inherent in the forced merger route. Further, it enables the FSLIC to devote more staff attention to resolution of truly serious cases involving problems of management or asset quality.

Beyond the question of extending the program, we believe a number of substantive changes in the program profitably could be made as proposed in S. 629, introduced by Senators D'Amato and Dixon of this distinguished Committee. That bill, for example, would clarify that the category of loss that may be covered by the NWC program includes losses from the sale of financial assets such as mortgages, mortgage backed securities, and municipal and other types of bonds. It also would permit the Bank Board to give aid to institutions that were below the current 0.5% net worth threshold, provided a sound business plan was submitted. In addition, it would enable the Bank Board, at its discretion, to extend 100% loss coverage on an initial basis to eligible institutions having less than 1% net

worth. We enthusiastically endorse these amendments and hope they will be included in any legislation enacting extension of the NWC program.

LIMITATION BY FHLBB OF POWERS OF STATE-CHARTERED THRIFTS

As this Committee is well aware, the Bank Board's concern for the FSLIC, as well as its interest in assuring the continuation of a reasonable degree of housing specialization, has led it to impose restrictions -- which, as a practical matter, apply mostly to state-chartered institutions -- on the ability of FSLIC-insured thrifts to make investments in equity securities, equity interests in real estate, and service corporations. In addition, the agency in section 5 of S. 1167 has proposed to prohibit FSLIC-insured institutions from making any investments or engaging in any activities other than those permitted for federal associations and multiple savings and loan holding companies, and those determined by the Bank Board to be a proper incident to the operations of insured institutions and not detrimental to the interests of savings account holders therein. Last week, the Bank Board, in connection with the House Banking Committee's mark-up of legislation (H.R. 20) dealing with closing the non-bank bank loophole, revised this request in favor of a formulation that

would give the agency discretion to determine whether or not an activity available to state-charted FSLIC-insured institutions should be regarded as an "improper incident to the operations of an insured institution."

Notwithstanding our reservations regarding the impact on the dual system of federal/state regulation of financial institutions of the Bank Board's regulatory and proposed legislative actions, the League has supported the imposition of reasonable restrictions on the activities of state institutions. Given the existence of federal deposit insurance, it is difficult to deny the legitimacy of the federal interest in the area. This vital balancing of interests contributed to our decision in January to support the FHLBB's revised direct investment regulations. The House Banking mark-up's language would buttress that regulatory initiative earlier this year.

In terms of the legislative alternatives in those areas, however, the League prefers the approach embraced by the Bank Board in the recent Housing Banking mark-up. It is constructed in a way that would require the agency to focus on a particular activity and determine its unsuitability for savings institutions. In effect, the burden would be on the Bank Board to propose regulations, with an opportunity for public comment and review, in contrast to the section 5 of S. 1167 approach,

which essentially would outlaw automatically state powers beyond those available to federally-chartered associations or those found on the multiple savings and loan holding company "laundry list". The mark-up solution represents a rifle-shot-type response to problems arising from state empowerments, and would be far better suited to dealing with them than would section 5, which the League would have to oppose vigorously.

MANAGEMENT SHARING PROGRAM

In the League's view, one of the most promising approaches to protecting the FSLIC is represented by our recently proposed Management Sharing Program. The premise upon which the program is based is that, considering the pressure on the FSLIC fund, the agency's case load, and the tremendous strain that case load has caused for FSLIC staff, it is essential as a cost-reduction measure that FSLIC begin employing expert industry resources, on a routine basis, to manage problem physical assets and problem institutions.

To assure the best resolution of situations involving problem physical assets, each FHLBank would establish at least one Regional Advisory Committee (RAC) that would identify experts who would be employed to manage such assets. RACs

would be made up of the Principal Supervisory Agent, the state supervisor (where state-chartered, FSLIC-insured institutions are involved), a local FSLIC representative and representatives from local savings institutions. RAC recommendations would be approved automatically under delegated authority if the amount of funds involved were below a specified figure.

In a similar vein, FSLIC would rely routinely on a "consignment" approach to dealing with problem institutions. This would involve hiring management expertise from other savings institutions (or commercial banks, if necessary) as a means of minimizing the cost to the FSLIC for resolving problem cases. Management agent selection would be a PSA responsibility, which would be exercised pursuant to specific criteria, such as the willingness to place any capital at risk in the arrangement, past track record, business plan and so forth.

The League has communicated a detailed description of the program to the Bank Board, which already has had some experience with approaches somewhat resembling the one we are suggesting. We are quite enthusiastic over the cost-saving potential of our program, and are very hopeful that the Bank Board will embrace it as its own.

POWERS OF THE FSLIC AS RECEIVER

A further step that the Bank Board would like to take to protect the FSLIC concerns the powers of the latter as receiver. Title IV of S. 759 would provide a statutory framework that would govern the FSLIC's conduct of receiverships. Existing statutes currently provide very little guidance in this regard, and the agency's rulemaking efforts on the subject have been similarly sparse.

The League is broadly supportive of the Bank Board's efforts in this area, although there appear to be some provisions of Title IV that may need modification. For example, the bill would create a special priority status for security interests obtained in connection with FHLBank advances. The security interest of a FHLBank, in effect, would be deemed perfected when created. It is unclear what the impact of this provision would be on the ability of institutions, most especially those in financial difficulty, to raise funds other than through FHLBank advances.

In addition, Title IV raises rating problems with regard to debt securities secured by pledged collateral, in that it may interfere with the ability to use or liquidate collateral to pay certain kinds of indebtedness in a timely manner. It is the League's understanding, however, that the Bank Board staff is working to cure this problem.

A final concern we have has to do with the priority treatment of savings accounts. S. 1167 would establish a higher priority for insured accounts than for uninsured accounts. This approach, which is not suggested in S. 759, would allow the FSLIC, in the exercise of its subrogation rights vis a vis insured depositors, to claim a larger portion of the receivership assets than it could if it were to continue to be treated as an undifferentiated general creditor. Again, we are uncertain just what the business impact of this step would be.

ELIMINATION OF NON-BANK BANK LOOPHOLE

The U.S. League has been emphatic in our opposition to the continued chartering and operation of non-bank banks and we hope this Congress will succeed in bringing an end to the loophole bank phenomenon. The questions of geographic spread of banking institutions and their affiliations with non-financial organizations are too fundamentally important to be dealt with other than at the Congressional level.

Apart from the broad structural questions raised by the presence of non-bank banks, the League also is gravely concerned about the impact of these institutions on the FSLIC. As sanctioned by Title I of the Garn-St Germain Act, the Bank Board, in effect, has been auctioning off interstate entry

rights as a means of preserving the FSLIC fund. The availability of non-bank bank charters, however, has acted to dull interest in acquiring one of the FSLIC's failing thrifts; even with FSLIC financial aid, it obviously will in most circumstances be cheaper to establish a new institution than to try to turn one around that has a history of losses. Accordingly, we believe the pressures on the FSLIC caused by non-bank banks supply an independent basis for eliminating those organizations.

In terms of a grandfather date for loophole banks, the League continues to support a July 1, 1983 cutoff date. We hope whatever bill the Committee ultimately approves will preserve this 1983 date.

U.S. LEAGUE OPPOSES NON-SUPERVISORY TAKEOVERS OF THRIFTS BY COMMERCIAL BANKS

Another structural-type issue that we would look to address briefly concerns the issue of whether commercial banks should be able to acquire control of savings institutions. As you know, the League strongly opposes such acquisitions, except in the supervisory context.

Our basis for opposition essentially is that such affiliations essentially will be entered into by banks desirous

of advancing their commercial banking business, rather than of devoting more resources to the kinds of mortgage-lending-related activities characteristic of savings institutions. The result of such an association over time, of course, necessarily would be a transformation of the thrift into a commercial banking institution. Allowing unrestricted takeover of savings institutions by banks, accordingly, in our view, would be inimical to maintenance of the acquired institutions' status as specialized housing lenders, and would tend to undermine the savings institutions industry's mortgage credit concentration. This is a genuine threat to home finance, unlike the powers granted by the Garn-St Germain Act or an appropriately flexible qualified thrift lender test.

NEED TO LIMIT SAVINGS INSTITUTION AFFILIATION WITH SECURITIES FIRMS

Another structural issue of considerable interest to the U.S. League concerns the question of affiliations between securities firms. As the U.S. League testified last year, we strongly favor forbidding acquisitions of thrifts by underwriters or market-makers in equity securities (or vice versa).

I must emphasize, however, that we do not support a wholesale application of Glass-Steagall to our industry at this

late date. Particularly as a consequence of our real estate and insurance affiliations, long sanctioned by Congress through, inter alia, the unitary savings and loan holding company format, strict interpretation could disrupt the formation of mortgage-backed securities, sale of loans with recourse, sale of annuities, real estate joint ventures and perhaps other activities which might technically be deemed to involve "securities" issuance, underwriting and sale. This obviously would be an expensive and disruptive result, and one in our view that would serve no purpose. Your bill, S. 2851, in the last Congress attempted to "carve out" exceptions to preserve these long-standing activities in language broadening Glass-Steagall definitional coverage to our industry. Amending the Savings and Loan Holding Company Act, as S. 759 recommends, is an even simpler solution to these legal uncertainties.

The League thus far would prefer the more targeted approach taken in S. 759 if the Congress wishes to clarify the separation of securities activities from activities of savings institutions. That bill would prevent FSLIC-insured institutions, FDIC-insured federals, and their holding companies from engaging (directly or indirectly or through a subsidiary) in the activities of an underwriter or of a market-maker in (1) equity securities, or (2) debt securities other than those secured by interests in real estate or that are eligible to be underwritten by national banks. This

trageted approach would assure the essential separation of institutions empowered to perform some commercial lending from the underwriting and marketing of securities for the same commercial enterprises; we believe that separation was sound public policy fifty years ago (when Glass-Steagall was enacted) and remains sound public policy today. It should be noted, however, that there is some question as to the possible impact of this provision on the ability of holding companies to sell their securities directly, using, for example, service corporation personnel as a sales force, rather than through a securities firm, and it may be necessary to seek an amendment to assure that such practices are not inadvertently banned.

NEED FOR RESTRICTIONS ON BROKERED FUNDS

Another issue with which the Committee is well acquainted is the League's position on brokered funds. Both the Bank Board and the FDIC would like to obtain legislation that would enable them to impose very tight restrictions on this form of funds acquisition.

As was noted earlier, the League supported the Bank Board in its regulatory efforts in this area, and continues to believe that the FDIC and the Bank Board should have broad authority to curb the use of brokered funds. Because of the usefulness in the restructuring context of longer term brokered money, however, we do not believe it would be appropriate to

place limitations on the use of such brokered funds -- except, of course, with regard to institutions that are supervisory cases.

NEED FOR EXPANSION OF FEDERAL ASSOCIATION SERVICE CORPORATION POWERS

At present, federal association service corporations are permitted to invest up to 3% of their assets in subsidiary service corporations, with 1/3 of that investment maximum dedicated to be used primarily for community, inner-city and community development purposes. Service corporations have emerged as important profit centers for our business, playing a particularly valuable role during the crisis of 1981-1982. In order to provide federals with the ability to take better advantage of the opportunities for profit that they have developed through their service corporations, the League urges you to approve a modest increase in federal service corporation authority from 3% to at least 5%. We note that the Bank Board, in S. 759, has proposed such an increase as well, although it would apply only to federals meeting the 60% qualified thrift lender test -- a linkage which we regard as inappropriate.

NEED FOR EXPANDED LIABILITY POWERS

As we testified last year, the U.S. League also supports greater authority in the liability area. Specifically, we

continue to endorse permitting federal associations to accept ordinary demand deposits from customers with which they do not have a "loan relationship," and removing the longstanding ban against the paying of interest on demand deposits. The loan relationship requirement has only served to complicate federals' efforts to gain corporate checking accounts and, by extension, commercial lending customers. There simply is no rational basis for interfering with federals' commercial lending power -- capped at 10% of assets -- in this manner. Furthermore, federal associations still do not possess demand deposit authority to serve individuals.

Concerning the ban on paying interest on demand deposits, this piece of protectionism is a total anachronism in a financial world characterized by the virtually total deregulation of almost every other category of deposit instrument. Absolutely no basis in sound public policy exists for continuing this situation, and we hope that Congress will move to complete deposit deregulation by elimination of this pointless prohibition.

U.S. LEAGUE SUPPORTS MUTUAL THRIFT HOLDING COMPANIES

One of the most creative aspects of last year's S. 2851 was its proposed authorization of mutual thrift holding companies designed to enable mutual institutions to participate in the

diversification benefits available to stock organizations in the holding company format. The League continues to support this concept, and hopes that it will be incorporated into any financial services bill the Committee may produce this year. Although the mutual thrift holding company is in no sense a substitute for a service corporation, for it is highly unlikely the Bank Board ever would sanction significant diversion of capital out of insured institutions to their holding companies, this nevertheless promises a new source of income and, hence, net worth, for mutuals that lack either the resources or the inclination to convert to the stock form.

U.S. LEAGUE OPPOSES RESTRICTIONS ON ADJUSTABLE MORTGAGES

The final issue I would like to address today, Mr. Chairman, is adjustable rate mortgages. Last year, S. 2851 as passed by the Senate, included an amendment, offered by Senator Metzenbaum, that would have permitted ARMs to increase no more than five percentage points over the life of the loan. This was a great disappointment for us, and we will oppose strongly any attempts in this Congress to place statutory constraints on these instruments. As we testified in April before several distinguished Subcommittees of this Committee, it is a fundamental matter for us as responsible financial intermediaries to reject a legislated 5% cap on mortgage rate adjustments, or other burdensome restrictions, as long as our

source of funds, consumer deposits, is approaching total deregulation. Adjustable rate mortgages are essential to the future health of our specialized savings institutions, particularly those which emphasize the role of portfolio lenders committed to the long-term credit needs of households. Widespread use of ARMs sustained the housing recovery throughout 1984. While we acknowledge that there have been some problems with certain types of variable loans, particularly the graduated payment mortgages, the marketplace is constantly improving the ARM product, and consumers -- with such new tools as the Consumer Handbook on Adjustable Rate Mortgages -- are becoming ever more knowledgeable in choosing the best mortgage for their home purchase needs.

It would be most unfortunate if the Congress, through adoption of statutory restraints such as last year's Metzenbaum Amendment, were to interfere with this salutory progress in developing adjustable rate mortgages. Market-determined adjustable-rate mortgages are essential if we are to maintain our enviable position as a nation of homeowners.

CONCLUSION

To conclude my remarks very briefly, Mr. Chairman, let me emphasize that, from the standpoint of this testimony, the U.S. League wishes to highlight three things. First, it is

essential that we have a qualified thrift lender test in place to allow our institutions, consistent with the intent of the Garn-St Germain Act, to make reasonable, unpenalized use of their new powers as a means of strengthening their role as residential real estate lenders. While the S. 2851 test is a good product, it definitely is in need of modification -- particularly in the all-important liquidity and mortgage banking areas. A properly crafted standard could prove invaluable as a device for establishing a logical line of demarcation between the savings institution and commercial banking industries and for providing institutions with a greater degree of choice in determining their own location in the financial landscape.

Second, we believe that it is essential for Congress to consider the FSLIC-strengthening steps we have urged, particularly those dealing with enforcement powers and freeing the agency from hiring, firing and compensation constraints. The League most emphatically does not believe, however, that the process of improving our supervision through strengthening the FSLIC can be replaced by merging the FSLIC with the FDIC. To the contrary, we are convinced this step would result in a less coordinated approach to thrift supervision and regulation, as well as lead to the ultimate unravelling of the entire federal structure designed to foster institutions specializing in the provision of housing credit.

Finally, the League is committed to the preservation of a regime of flexibility in the vital ARM area. We hope the Committee will reject any attempts to place mandatory interest increase caps or other burdensome restrictions on this valuable instrument.

Mr. Chairman, this concludes my remarks. I will be happy to respond to any questions you may have.

Thank you.

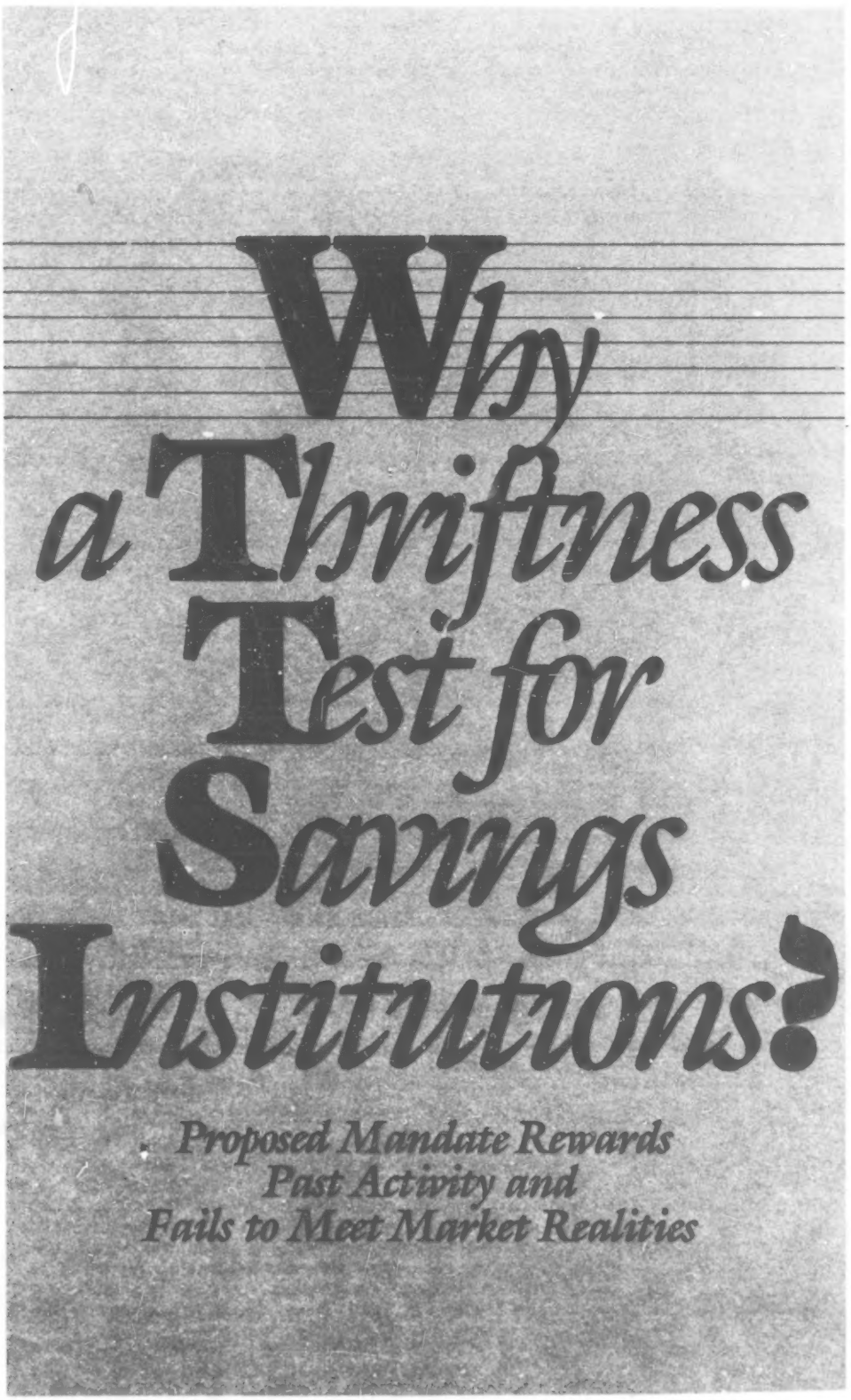
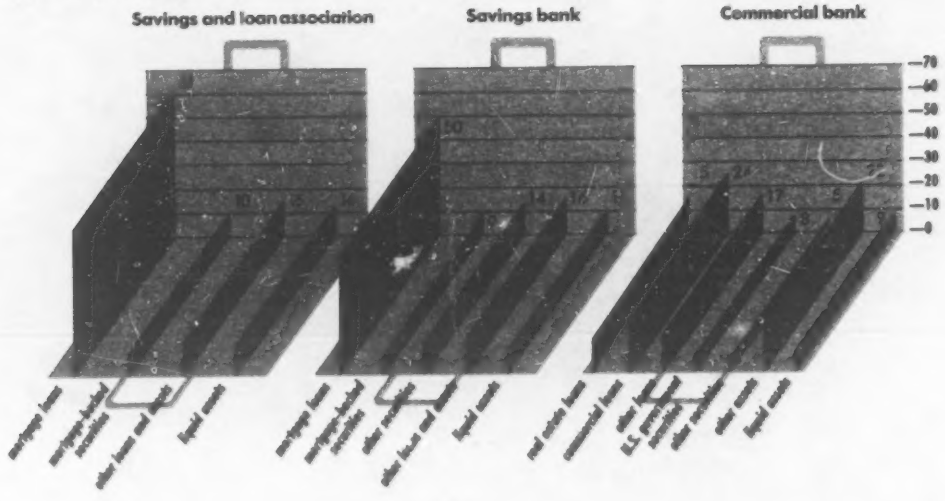

Why a Thriftness Test for Savings Institutions?
Proposed Mandate Rewards Past Activity and Fails to Meet Market Realities

Figure 1
TYPICAL PORTFOLIOS



SOURCE: National Council of Savings Institutions.

NOTE: These figures are for typical institutions—i.e., a savings and loan association with about $250 million in assets, a savings bank with about $350 million in assets, and a commercial bank with about $500 million in assets.

by Saul B. Klaman

By the time this article appears, Congress may well have enacted a "Thriftness" test for savings institutions in connection with legislation to close the "nonbank bank" loophole. Whether or not this is the case, the concept and philosophy underlying the test, as well as the nature of the test itself, will generate continued serious interest among participants in, and observers of, the financial marketplace.

First, in a financial world of largely deregulated liabilities, restricted asset choices for one class of depository institution are both unfair and unsound. Second, the nature of the test itself—it is based primarily on portfolio holdings—may be questioned on grounds of equity and practicality.

Saul B. Klaman is president of the National Council of Savings Institutions, Washington, D.C. *The author gratefully acknowledges the assistance of John A. Tuccillo, vice president and chief economist of the National Council.*

ELEMENTS OF THE TEST

The test is designed to ensure the continued orientation of the savings industry toward housing finance. It mandates that a savings institution hold 60 percent or 65 percent (the Senate and House versions differ) of its assets in residential mortgage loans and related assets.

So soon after the Garn-St Germain Depository Institutions Act of 1982 recognized the need for greater asset flexibility in savings institution portfolios, why such a turn toward greater asset rigidity? In the view of some legislators and regulators, the test's purpose is to distinguish savings institutions from banks for purposes of the Bank Holding Company Act, or to justify the existence of, and eligibility for, benefits of the Federal Home Loan Bank System.

With respect to the bank holding company issue, the test implies that the institution must be a commercial bank unless it holds the bulk of its portfolio in residential mortgages and related assets. There is no middle ground. The institution's portfolio may be radically different from a commercial bank's—few, if any, commercial loans, no foreign loans, large residential mortgage loan holdings (figure 1)—but it would still be regulated under the Bank Holding Company Act.

Radical Market Changes May Not Safely Accommodate Statutory Asset Restrictions

Something is wrong here. Many institutions across the country, both savings banks and savings and loan associations, may be unable or unwilling to hold 60 percent or 65 percent of their assets in residential loans and related assets—yet they do not operate as commercial banks or wish to convert to commercial bank charters. An unrealistic test of their "thriftness" may push them in the commercial bank direction, which would hardly achieve the legislatively desired thrust toward housing.

The issue with respect to the Federal Home Loan Bank System is somewhat different. Here it is a matter of justifying the existence of a separate regulatory structure for savings institutions. The need for some justification has arisen largely as a result of the deliberations of the Vice President's Task Group on Regulation of Financial Services.

It is argued that the System was established as a support facility to serve its members who ". . . provide for the financing of homes"; absent such a purpose, the reason for a Federal Home Loan Bank System collapses. And unless a savings institution serves such a purpose, it is not entitled to the benefits the Bank System provides.

The rationale for the view of the Bush task group is understandable. What is strangely overlooked, however, is whether the task group's proposals are consonant with market realities. There seems to be little concern that radical changes in the financial marketplace, and particularly in the mortgage market, may not safely accommodate statutory asset restrictions on savings institutions. Nor has the appropriateness of the proposed test itself been seriously questioned. And there has been little or no discussion of whether the purpose of, or criteria for membership in, the Federal Home Loan Bank System should be modified.

Relevance of the Test

Whatever justification there may be for a statutory mortgage requirement, the marketplace will ultimately decide its effects. And radical changes in mortgage finance and markets, in the delivery of financial services, and in interest rate movements challenge the logic of mandated residential mortgage holdings for any type of financial institution.

First, since the late 1970s, the U.S. economy has been subjected to chronically high and volatile interest rates. It would be foolhardy to bet on a return to stability as a basis for legislation. Interest rate volatility causes havoc in housing markets, makes the level and change in demand unpredictable, and therefore requires maximum flexibility in asset management of financial institutions. Heavy investment in fixed-rate long-term mortgage assets is hardly recommended in such an environment. And adjustable-rate mortgages—once considered to be the lender's panacea—offer only limited protection against sharp interest rate swings.

Second, many savings institutions are already questioning the profitability associated with traditional home mortgage lending. Accelerating competition in the mortgage lending business has narrowed spreads significantly, relative to other kinds of loan and investment activity. Traditional savings institutions that operate out of expensive brick-and-mortar facilities are at a considerable disadvantage compared with newcomers who are exploiting a rapidly improving electronic technology.

Third, there has been a virtual revolution in the mortgage market itself. Many new players have entered the game, mortgage-backed securities have become the darlings of the investment banking community, and mortgage finance is not only integrated with domestic capital markets but is part of the international markets as well. Traditional mortgage lenders and holders, still the largest source of permanent mortgage capital in this country, may soon lose their dominant place among a whole new host of suppliers. With housing demand and interest rates increasingly volatile, with mortgage capital coming from broadened national and international sources in more sophisticated markets, how long will a legislatively mandated, quantitative mortgage requirement for the savings industry make sense?

Dangers lurk ahead on both the demand side and the supply side of the market. Of course, any test can be structured to be relatively easy or difficult to meet, and the specifics are quite important. Specifics aside, the concept of a quantitative legislative asset test is inconsistent with market realities in a deregulated and rapidly changing financial world.

Reward for Past Activity

The proposed residential mortgage test is based primarily on portfolio holdings. The mandate for savings institutions is to hold a stated percentage of assets in residential mortgage and related loans. The development of such a test is not hard to understand. It is based on precedent—the Garn-St Germain Act's uni-

Traditional Mortgage Lenders And Holders May Soon Lose Their Place Among A Whole New Host Of Suppliers

tary savings and loan holding company test, for example. Precedent alone, however, cannot justify a legislative action bearing on a radically changing financial marketplace.

A portfolio test essentially rewards past activity—it looks backward, not forward. It favors firms currently well above the threshold and penalizes those below it. Even allowing for a gradual phase-in of several years, it will require those institutions well below the test threshold to run quite fast to catch up.

Over 10 years, assuming an annual average growth rate of 5 percent, an institution now holding 40 percent to 60 percent of its portfolio in qualifying assets would have to place from 74 percent to 110 percent of its asset growth per year in qualifying loans to meet a 65 percent test (table 1). An institution now holding more than the required percentage of qualifying assets could operate for years with a much lower net investment in housing, allowing its mortgage portfolio to run off and actually reducing its support for housing.

Table 1
Asset Distribution:
Meeting a 65 Percent Portfolio Test

Initial Percentage of Portfolio in Qualifying Loans	Percentage of Annual Portfolio Growth to Be Invested in Qualifying Loans	
	5% Annual Asset Growth	10% Annual Asset Growth
40	110	83
50	92	76
60	74	69
65	65	65
70	56	61
80	38	54

NOTE: These figures suppose a 10-year period in which to meet the requirements.

More importantly, perhaps, the former institution would be at a severe disadvantage relative to the latter, having been denied much-needed flexibility to pursue risk reduction strategies in volatile financial markets.

Any test, of course, can permit exceptions and incorporate allowances for special circumstances and times. The more flexible the test, and the broader the inclusion of assets, the better it will be. But there is no escaping the inequity of a portfolio test. It falls with an uneven hand on institutions operating in different markets, in different geographic areas, and with different current portfolio holdings.

Are There Alternatives?

One obvious omission of a portfolio test is that it gives no credit for loan origination. The Federal Home Loan Bank System's mission to provide for housing finance hardly seems to require that all loan originations be retained in portfolio. Some allowance for originations would clearly be justified. Indeed, new lending might well be a better basis for a test than holdings. Any test designed to measure current support for housing finance should allow savings institutions to enter the starting gate on equal terms.

Requiring some institutions to start well behind others and then forcing them to catch up, even over years, can hardly be called evenhanded. Past performance is history; future performance will support housing markets. The flow of funds, not the stock of holdings, is relevant in current markets.

It still seems obvious that any simple arithmetic test is unrealistic and unfair in the complex and widely varying mortgage markets in which the nation's savings institutions operate. It would be far more reasonable for Congress to declare its intent and instruct the appropriate federal regulator to apply flexible standards to determine a savings institution's orientation to housing.

This is hardly a novel suggestion. Statutory housing finance tests have been proposed before and rejected as too inflexible. When the federal savings bank statute was enacted in 1978, such a test was proposed, and rejected by Congress. Failing at the legislative level, a similar test was proposed at the regulatory level to the then-chairman, Robert H. McKinney. In rejecting that proposal, McKinney stated that ". . . a rigid quantitative home-financing test would prevent the Board from taking into account local circumstances and conditions." In reviewing federal savings bank applications under McKinney, the Bank Board judged each institution's housing orientation according to its market. Under broad and flexible guidelines, this approach could be used in today's and tomorrow's continually changing financial and mortgage markets.

Need for Housing Bank?

Recall that a major reason for a residential mortgage test is to justify the existence of, and membership in, the Federal Home Loan Bank System, a unique regulatory body. But if a radically changed market refuses to adjust to the regulatory structure, it might be logical to take another look at the structure. This brief article is not the place for a searching examination of the Federal Home Loan Bank System, but some issues might be worth exploring.

A Separate Regulatory Body For The Nation's Savings Institutions Remains Eminently Justified.

First of all, it is clear that a separate regulatory body for the nation's savings institutions remains eminently justified. Even apart from housing finance, there are enough significant differences between commercial banks and thrifts to warrant separate regulatory structures. The pursuit and stimulation of savings remains a hallmark of savings and loan associations and savings banks, and this objective can be found in the charter of the Federal Home Loan Bank System as well. What more important objective can there be in a nation that saves at one of the lowest rates in the Western world? Finally, competition at the federal financial regulatory level can be quite healthy, in contrast to a monolithic system.

There is no need to remain tied to the purposes and objectives of 50 years ago. Perhaps the Federal Home Loan Bank System might function as a housing bank, providing appropriate services (including reserve credit) to all major suppliers of housing credit, varying benefits in relation to the degree of each supplier's support for housing, but not mandating some arbitrary threshold or all-or-nothing participation. This would clearly acknowledge the vast changes in the mortgage marketplace and yet not penalize savings institutions if they did not maintain the bulk of their assets in residential mortgage loans.

If housing is a high public policy priority, then a housing bank makes good sense. Of course, it is hardly a unique concept. Such institutions exist in many other countries. And a housing bank might well ensure a more stable flow of home mortgage credit, from a broadened base of suppliers, than a narrow portfolio thriftness test limited to one class of institution.

A More Realistic Test

Any legislatively established economic or financial test cannot long survive without causing considerable disruption if it violates the realities of the marketplace. The broader and more flexible the test, the closer it will be to the market reality, and the longer it will survive. A test based on prospective, rather than retrospective, activity will be more equitable and better achieve its purpose. The most flexible and realistic test of all would be one that gave the federal regulator authority to vary requirements according to institutional, market, and geographic differences.

The Federal Home Loan Bank System needs no new justification for its existence. It should remain the primary regulator and insurer of the savings industry. Apart from its home financing function, this industry remains the nation's primary motivator and gatherer of savings.

Finally, the concept of a housing bank might be worth exploring. Such a facility (within the Federal Home Loan Bank System) would act to support all major suppliers of housing credit in providing a broadened and more stable flow of mortgage funds throughout the housing cycle. ■

The CHAIRMAN. Thank you, Mr. Brooks.
Mr. Albers.

STATEMENT OF KENNETH F.X. ALBERS, CHAIRMAN, PROVIDENT SAVINGS BANK, JERSEY CITY, NJ; CHAIRMAN, NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. ALBERS. Mr. Chairman, the National Council of Savings Institutions has also filed some written testimony and I would appreciate it if that could be in the record.

The CHAIRMAN. Your written testimony will be in the record.

Mr. ALBERS. Let me try to just summarize briefly rather than reading the text I have in front of me.

I think one of the most outstanding features of the financial business since June 1978, is the rapidity of change. That is when the first market related account was adopted by the banking industry.

PROCOMPETITIVE

This committee has heard testimony earlier from representatives of Sears, Roebuck and Beneficial and it's quite obvious that they intend to provide a rather wide variety of financial services to the American public.

The National Council of Savings Institutions and its predecessor organizations have always been procompetition. We think the American public is better served by the financial system if we can meet fully the competition raised by traditional nonbanking competitors.

We feel that the ability to operate profitably by choosing to offer a diversified line of services or to specialize, as the case may be, will result in profitable operations and enhance public confidence in our institutions.

We realize that with deregulation and more powers added to what financial institutions can do that it does require more supervision and more quality type examination and examination staff. We commend the Federal Home Loan Bank Board for their recent vote putting examiners under the Federal Home Loan Bank Board, in order to enhance salaries and so forth.

The National Council of Savings Institutions would hope to be able to work with you and this committee later on in establishing some type risk-based insurance for FSLIC and FDIC. We think that's clearly in order. We think finding the proper formula is the difficulty.

The present proposal on the table would merely differentiate on the basis of Federal or State charters and we think that is not the proper approach. It has to be looked at differently, but we do favor risk-based insurance.

The National Council of Savings Institutions has a committee working on long-term solutions to the insurance problem.

We also have a short-range committee that was chartered just 2 or 3 weeks ago when I became chairman of the council to have a look at more short-range solutions in the framework of deregulation.

The thrift test to us represents an unnecessary burden and restriction on the ability of financial institutions to compete. We think the right way to go is diversified powers to be used by each institution as its capability and expertise allows. The thrift test per

se would also transfer to the Federal regulators the authority to grant or take away powers that have been granted to us by our State charters. Provident Savings Bank is a State-chartered mutual savings bank in New Jersey. We have had a broad array of powers for 9 years in New Jersey. Many of our institutions are using them—real estate development being one—and to date there is absolutely no evidence on the record to indicate that diversification does anything but aid a bank or association.

We realize the expertise of many of the institutions is in the mortgage field and indeed we don't see people fleeing the mortgage field by any means. What we are looking for is a balanced composition of powers so that those institutions that wish to diversify have the right to do it; those which wish not to have that right as well.

The mortgage market itself, Senator, has changed drastically. There are a lot of new players in the field. Prudential Insurance Co. in New Jersey announced a couple weeks ago that they are coming in the direct mortgage business for the first time in many, many years. So, too, have other competitors in mortgage-backed securities, pension funds. The ingenuity of different players in the mortgage market all indicate to us that the mortgage market will be much more competitive in the future than it has been in the past and tradition says the more competition that's in the field, the lower the prices are and the lower the profit margin.

So we think the thriftness test, boxing institutions into one type involvement, is not in the best interest of the American public and certainly not in the best interest of the financial institutions.

Last, we have supported this committee's thrust over the years. In last year's bill, while—we had differences on some of the areas and some of the details as you know, but basically, Senator, we feel that your committee was on the right track. Deregulation is in fact the answer.

We think the financial institutions will be much better off with broad powers if prudently used. Many people have come in and tried to tie in some of the recent financial disasters that occurred in Ohio and Maryland to the broad powers. It's simply not true.

The institutions who got in trouble there got in trouble by making traditional investments permitted to financial institutions for 100 years. So we really feel that the deregulation thrust is correct.

The National Council of Savings Institutions supports this thrust and we look forward to working with you and this committee.

The CHAIRMAN. Thank you very much, Mr. Albers.

[The complete prepared statement follows:]

Statement of
Mr. Kenneth F. X. Albers

on behalf of
The National Council of Savings Institutions

Mr. Chairman, my name is Kenneth F. X. Albers and I am the Chairman of the Provident Savings Bank of Jersey City, New Jersey. It is my pleasure to appear here today in my capacity as Chairman of the National Council of Savings Institutions. The Council is just over a year old, having been formed by a consolidation of the National Savings and Loan League and the National Association of Mutual Savings Banks. The Council represents about 600 savings institutions with aggregate assets of over $400 billion.

Mr. Chairman, my mission here today is to express to this Committee the National Council's continued commitment to the process of expanding competition in the financial services industry.

We supported the product flexibility emphasis of S. 2851 in 1984. The bill was far from perfect from our point of view but it did, throughout the process, represent a big step in the direction of financial deregulation. As such, it was consistent with the statement of principles of the NCSI by which we are committed to a regulatory framework in which all depository institutions can "compete effectively and fairly in the rapidly changing financial services marketplace as it exists today and as it evolves in the future."

Chairman Garn has asked us all to present our views as to what has happened since September 1984 and in what way events call for a different legislative approach, if any.

The intervening events have been well publicized and discussed by many witnesses already in this round of hearings. The financial calamity in Ohio and Maryland, the bank failures, the special assessment of FSLIC premiums - all seem to suggest to many observers that further deregulation is out of fashion. Indeed we are already hearing some calls for returning the thrift industry to the regulations of the past.

It is our considered opinion, Mr. Chairman, that nothing has happened to diminish the need for Congressional action to unshackle the nation's depository institutions so they can compete with the universe of financial service providers. Witnesses before this Committee in recent weeks have made it abundantly clear that the financial conglomerates such as Sears, Beneficial and others are proceeding full tilt with their plans to provide an even broader array of financial services. Their efforts to cross sell and integrate services offers the American consumer an ever-expanding menu of options. The National Council applauds these developments. We again urge the Congress to address these developments with comprehensive financial reform legislation which will give depository institutions comparable flexibility in the marketing of customer services.

We are well aware of the progress of legislation on the other side of the Capitol. The legislation reported by the House Banking Committee to close the nonbank-bank loophole may very well pass the House in coming weeks. This despite the developments in the courts which have made the non-bank bank an academic issue. It seems clear that the House Committee is intent - not just on holding the line but, rather, on turning the deregulation clock backward - particularly with respect to the thrift industry.

Not only are we opposed to some aspects of the loophole bill (the thrift test), but more importantly we fail to see the reason for it. It would appear that the once perceived horrors presented by non-bank banks and the invasion of the money center banks have both been put to rest by the courts. If there is no non-bank bank loophole, then why waste legislative time on these issues. It would be a far wiser use of time and energy to fashion a comprehensive reform package which would provide for product expansion and an orderly transition to nationwide banking. Our reading of the political winds tells us that such a goal is getting harder and harder and may be far from the minds of many members of Congress. If indeed this is the case then in our opinion, no legislation is better - far better - than regressive legislation.

Deregulation - narrowing the concept

It is high time, Mr. Chairman, that all of us on this side of the table clarify what we mean when we speak of regulation - deregulation and reregulation. If I can refer back to earlier testimony presented here by the Council and its two predecessor organizations, I think it is clear that what we have been advocating is the elimination of artificial and outdated barriers to competition. And, the recognition of each of those barriers was being effectively eroded by market forces to such an extent that they had lost their original meaning and served only to create a climate of unfair competition between players in the financial services markets. Perhaps we never should have called this "deregulation" but we did.

We never meant or suggested that institutions should be permitted to engage in unsafe or unsound practices or that the examination/supervision

process should become less rigorous. What we should have said three or four years ago and what should be obvious now, is that as products and services are deregulated, examination and supervision become even more important and must be enhanced.

Thrift Industry Condition

To the extent that the news media covers financial matters it is usually to report bad news. That is not a criticism of the press but a reality we all must recognize. The present "media climate" is not a positive one. Bank and thrift failures and supervisory mergers of the past two years have led many to the easy conclusion that product deregulation and asset diversification are the cause of the problems. Observers in and out of Congress are blaming "deregulation" for high risk investments and thrift failures. We submit that upon closer examination of the recent thrift problems the blame more accurately rests on mismanagement and in some cases perhaps outright fraud or negligence.

The high profile-media hyped thrift failures have been associated with deregulation, with "high risk," "speculative" and "new" activities. Actually, none of those characterizations are accurate. Direct real estate investment, for example, has been a traditional thrift activity in several states for decades, Federal S/Ls have engaged in this activity through service corporations for some time before Garn-St Germain as well.

To cite the Ohio and Maryland cases as evidence for limiting the investment powers to thrifts is to miss the point altogether. The most

essential point in all these cases is that a badly or fraudulently managed bank or thrift will be brought to ruin regardless of the investment opportunities available. Much of the current argument for restricting thrift powers rests on the assumption that home mortgage lending is "less risky," as well as "traditional" and "safe." If only thrifts had "stuck to mortgages" they would not get into trouble. All of these assumptions are in error as was seen in the 1930's and again in the 1980's.

Different kinds of investments represent different kinds of risks but not necessarily greater or lesser degrees of risk. A long term fixed rate mortgage can be very risky in an unstable rate environment. Any mortgage, fixed or variable, can be highly risky without the proper underwriting standards. Likewise, a commercial property loan, consumer loan, residential real estate project all represent risk - but the risk is not the same when undertaken by people who know what they are doing or by those who do not.

Simply put, not all real estate development projects represent unacceptable risk - not all home mortgages represent acceptable risks. People who manage depository institutions are in the business of managing risk. That is what we are trained and rewarded for - the proper management of risk.

The proper response to the recent thrift problem is, in our opinion, to strengthen and enhance the examination and supervision capacity of the regulatory agency. The Federal Home Loan Bank Board recently took the first major step in that direction. By transferring the examination staff to the district banks we can expect, over time, a better paid, more career directed and better qualified examination staff. If this is not accomplished soon, no

amount of regulation writing in Washington can do any good.

The next step which must be taken by Congress is the development of a variable premium system for the FDIC and FSLIC. We recognize the controversy and reservations about this issue but we see no long term alternative. The job will not be easy and we do not believe that the proper system has yet been devised. The proper risk based system must measure different kinds of risk and must be based on objective standards to assure that premium assessments on institutions from coast to coast will be comparable and bias free.

At the present, the thrift industry is enjoying the benefits of low inflation and declining interest rates. For the past two years, the industry has reported net profits and the number of institutions with bottom-line losses has dramatically fallen from 76 percent of the industry in 1982 to 30 percent of the industry in 1984. More importantly, the sales of assets that have produced capital and generated these bottom line figures have given way to true operating profits; in other words, our institutions are beginning to make it on their investment earnings rather than eating their capital. For 1985, we forecast another profitable year, with a real potential of exceeding the $3.8 billion earned in 1978, so we look to the future with hope.

This welcome profitability has enabled thrifts to rebuild their capital positions. If our forecasts for 1985 are accurate, we will see an increase in the industry's capital ratio of one-half of one percent. This is significant in that it is the result of internally-generated funds and will thus make the industry more attractive and thus better able to raise capital from external sources. Thus it will have a multiplied effect on the health of the industry.

Moreover, the increase in capital in the industry will remove pressures from the Federal insurance agencies, particularly FSLIC, enabling them to address more effectively those problem cases now dragging at their reserves.

While we owe a great deal of this improvement to the general economy, much of the rebound of the thrifts has occurred because of the restructuring afforded them under powers granted in the Garn-St Germain Act. We are seeing a more intensive use of the secondary market to liquify old mortgage portfolios and devote the proceeds to the diversification that will strengthen the industry. The temptation at this time is to believe that circumstances will permit a return to the "good old days" when thrifts could profitably raise short term funds to finance investments in thirty-year mortgages.

Now the spreads are really between short funds and intermediate term investments. The current yield spread between 30-day and seven-year instruments is now in the neighborhood of 250 basis points; going further out the maturity spectrum adds little to this differential. We can capitalize on the spread by using our hard-won powers to create a new sort of thrift portfolio, one that exploits market conditions to generate profits.

We are not arguing that the thrift industry should abandon housing; nor do we believe that it ever will. We are merely saying that strength will come through diversification. The studies commissioned by the Federal Savings and Loan Advisory Council, hardly an anti-housing voice, show clearly that savings institutions cannot long survive by investing in long-term mortgages. Even adjustable rate mortgages are so hamstrung by caps and limits that they too are ultimately of limited value. We need to continue the restructuring

process so that savings institutions can diversify to the point where they can withstand a variety of economic conditions.

All this suggests that now is not the time to force the industry back into the old mold either through bad advice or ill-considered reregulation. We are aware of the problems that have been caused in recent years by excessive innovation and risk-taking by some institutions. The most serious upshot of this is the threat it poses to the deposit insurance funds. At the Council, we are conducting two separate studies, each the subject of a task force of industry executives. The first has been concentrating on alternatives to the current system of deposit insurance, and is now considering the nature of an effective risk-based premium system. This system would encompass all aspects of the thrift operation, including portfolio composition and interest rate exposure, capital base, and managerial competence. We expect their results in the fall.

The second task force, which I established when I took the chair of the Council, will look at pro-competitive alternatives to reregulation. our founding philosophy stresses the benefits to the financial sector of equal access and opportunity for all institutions regardless of charter. Guided by this approach, the task force will lock at methods of strengthening the insurance funds and of attracting capital into the savings industry from the outside. We believe that there are solutions to the lingering problems of the housing finance system that will maintain the freedom and flexibility for which we labored long and hard.

State Powers / Federal Insurance

The balance of authority, competition, and responsibility represented by the dual banking system has never been perfect. Yet we keep trying to find the proper balance, and for a good reason. There are definite benefits inherent in the dual banking system. That system is currently strained as much or more than any time in the past.

The current challenge to state authority takes many forms. The FHLBB direct investment regulation, the proposal to base insurance premiums solely on the difference between state and federal authorities, and most dramatically, the recent proposal to require all federally insured institutions to conform to one federally determined, set of investment powers.

There is also the example of the FDIC regulations adopted and proposed which would limit the providing of such services as insurance, real estate and securities through a holding company even when in many cases the services have been offered by state chartered savings banks for years. We are pleased to see that the FDIC has revised its proposed insurance regulation to exclude savings bank life insurance which has been offered by savings banks for many years.

All of these proposals are premised on one idea - that the federal government is smarter than the states or put another way - that if the activity was thought of in Washington it is "safe," if it was dreamed up in a state capital it is "risky." Obviously, no one would defend either of these propositions yet if you look at the aforementioned proposals these are the inescapable underlying principles. Not only are these assumptions simply wrong but if these proposals go forward we will lose flexibility,

experimentation and innovation that only the dual system will provide.

Having stated the Council's preference for continued state authority and initiative, I want to state at this point that the National Council is cognizant of the legitimate concern of federal regulators and the Congress about the long term stability of the deposit insurance system. The legitimate interest of the federal regulators in the safe and sound operation of insured institutions has never been questioned by the Council. Our support for better and stronger examination staff and procedures, as well as, our support for variable premiums,are rooted in the legitimacy of federal concerns and our desire to preserve state initiatives.

As recently as this past March at our Government Affairs Conference, our members took the position that the FSLIC and FDIC have a valid concern for the investment strategies of institutions which lack adequate capital and that those institutions should be closely monitored. On the other hand,so long as an institution exceeds minimum capital standards, then it is its own capital and not the insurance fund that is at risk in its investment decisions. So long as those investments are profitable they enhance the capital base and contribute to the overall health of the industry - thereby protecting the fund. In this case, we contend, the FSLIC and FDIC have no legitimate reason not to honor state authorities.

I would now like to address two issues from last year's legislation which caused a good deal of concern and dampened our enthusiasm for S. 2851, the thrift test and the extension of Glass-Steagall to thrifts.

Thrift Test

Several witnesses have appeared before this Committee urging the adoption of some sort of thrift test. While each advocate has his own test, they are all basically static, asset composition standards. Last year's House and Senate bills varied marginally on this point and the bill reported last week by the House Banking Committee draws somewhat from both of the 1984 bills. What all of these thrift tests, as well as those proposed by Chairman Volcker and Chairman Gray, have in common is that they are seriously misdirected and will do serious harm to the thrift industry in the long run.

Further encumbering thrifts with yet another, possibly more severe test can only serve to diminish the ability of our associations to respond to market forces and thus remain viable and competitive. Financial markets are neither static or predictable. Product and service innovations will continue as they have in recent years at such a pace as to make it impossible for any of us to predict what banks, thrifts or any other provider will look like five or ten years from now. That is our fundamental concern about the proposal for a static asset test.

Some of the proponents of a thrift test are motivated primarily by a concern that the thrifts have such a wide array of options that they will "desert" housing. We must address that concern directly. First of all, there is no evidence that in the one and a half years since the Garn-St Germain Act that thrifts have deserted housing. In fact, last year was a record year for mortgage lending by thrifts and this year should keep pace if not exceed that record. What is changing is the nature of the mortgage market. The role of

the secondary market, the innovations in securitization, the attraction of new providers and investors in the mortgage market all add up to very good news for home buyers, builders, realtors etc.. It adds up to narrower spreads and more competition for sound loans for us. What this means to us is that we will still be in the mortgage game for a long time to come, but the way the game is played is changing and we have to change with it. Therefore, when we hear and read proposals that suggest that the test of our commitment to housing is the extent to which we play by the rules of the 1950's we have to wonder who really has our best interests at heart.

Another argument recently put forth by thrift test advocates is the notion that such a test will somehow increase safety and soundness and prevent a recurrence of the Maryland/Ohio type of crisis. This is not only far from true but it is possible that the imposition of the test could weaken thrifts by reducing their profitability. In any case, it contributes nothing to safety and soundness. As we stated earlier, fraudulent or incompetent management will bring down an institution regardless of its lines of investment.

It has also been argued that a mortgage asset test is needed to differentiate between banks and thrifts or put another way, to justify the differences in the regulation of their respective holding companies. While this argument has the most legitimacy, it too is faulty. To the extent that the distinction needs to be made, we suggest that a test of "bankness" rather than "thriftness" is the most appropriate. If we understand the purpose of the Bank Holding Company correctly (the separation of banking and commerce) we submit that the proper test would be the extent of an institution's commercial

lending activity.

Our final argument against the thrift test is a practical one. Everyone on this Committee is vitally concerned, as are we, about the few hundred or so thrifts that are today so weak as to be irreparable. They represent a serious threat to the insurance fund and are the prime reason why the healthy FSLIC thrifts are forced to pay a special premium assessment. One solution to this problem is to sell their franchises to entities which have the capital to commit to them and are willing to make a long term commitment of the needed capital. Who has the capital? Insurance companies, securities firms, large bank holding companies and financial conglomerates. In short - the very interests that the Fed and the FHLBB do not want to see acquire any depository institution. The thrift test will only serve to make these problem charters unattractive to the only interests in any position to take them over. Given the seriousness of this problem and the importance of the FSLIC, we cannot understand why any responsible public official would do anything to make thrift charters less attractive at this time.

A good deal of time, research and internal discussion has gone into the development of our position on the thrift test concept. For the benefit of those who are interested in more detail on that analysis and reasoning, I have appended to my testimony articles prepared and published by National Council personnel which go into much more detail on the subject.

The Extension of the Glass-Steagall Act to Thrifts

The Glass-Steagall Act is one of the half century old "banking" laws

which needs a serious and thorough review - right down to its fundamental purpose. The Act was passed under circumstances far remote from today's financial services marketplace. Neither banks or securities were regulated in anything resembling the current body of laws and regulations. A good case can be made that the Glass-Steagall limitations are anti-consumer in that it prevents certain types of financial institutions from offering securities services. Therefore it makes no sense at all to extend the Act to institutions not currently covered by that 1933 statute.

Since the passage of S. 2851 by the Senate last year, the U. S. District Court for the District of Columbia confirmed the FDIC legal opinion that the Glass-Steagall Act does not apply to nonmember banks (ICI vs. FDIC, Doc. No. 83-2875, April 29, 1985). A number of savings banks have invested considerable time, money and management resources to new securities activities, and we do not believe that the court victory should be taken away as would have been done by last year's bill.

One of the arguments put forth for limited application of the Glass-Steagall Act to thrifts is the perceived need to bar ownership of thrifts by underwriters of corporate securities. The thorough review of securities and banking, we suggest, may reveal some needed restrictions in this area to protect the investing and borrowing customers. We would urge the Committee to consider for the short run that one of the critical issues to be faced this year is what to do with a few hundred very weak thrifts which presently are weakening the FSLIC. We submit that the best solution is to sell them to whoever has sufficient capital to acquire them. If you ban the big securities and insurance firms you have drastically reduced the available

capital for infusion into our industry. In short, Mr. Chairman, we cannot afford institutional parity given the present situation.

Conclusion

One of the many positive features of S. 2851 was the authorization of a holding company structure for those institutions which are and desire to remain in mutual form. Many uninterested or unaffected observers probably thought that part of the effort a waste of time. They were wrong. While the provision was not enacted here in Washington, the idea has caught on in many states. To date three states, Connecticut, New Hampshire and Washington, have adopted a mutual holding company statute modeled after the language in S. 2851. We find this development very rewarding and encouraging and hope that they will reinforce this Committee's support of the concept as it would affect federally chartered associations.

In conclusion, I want to express our deep appreciation and admiration for Chairman Garn's continued dedication to the process of an orderly reformation of our financial services landscape and a clear recognition of the inexorable forces and dynamic energy of creative people which is at the heart of innovation and change in our markets.

The CHAIRMAN. Ms. Chu.

STATEMENT OF BETTY TOM CHU, CHAIRMAN, MONTEREY PARK SAVINGS BANK, MONTEREY PARK, CA, CHAIRMAN, AMERICAN LEAGUE OF SAVINGS INSTITUTIONS

Ms. CHU. Mr. Chairman and members of the committee, my name is Betty Tom Chu. I apologize first of all for the airline schedules from California which made me a little bit late this morning.

The CHAIRMAN. You're right on time for your testimony.

[The complete prepared statement follows:]

American League of Financial Institutions
1511 K Street, N.W. Suite 510
Washington, D.C. 20005 202/628-5624

STATEMENT OF THE

AMERICAN LEAGUE OF FINANCIAL INSTITUTIONS

BEFORE THE

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

CONCERNING

OVERSIGHT HEARINGS ON THE FINANCIAL SERVICES INDUSTRY

JUNE 18, 1985

PRESENTED BY: BETTY TOM CHU
CHAIRMAN OF THE BOARD AND PRESIDENT
MONTEREY PARK SAVINGS BANK
MONTEREY PARK, CALIFORNIA

Mr. Chairman and members of the Committee, my name is Betty Tom Chu. I am Chairman of the Board of Directors of the American League of Financial Institutions.

The American League, formerly named the American Savings and Loan League, Inc., is a national trade association that represents the 75 minority savings and loans and savings banks that are owned or controlled by Blacks, Hispanics, Asian-Americans and women's groups. The American League in part is funded by the Minority Business Development Agency of the U.S. Department of Commerce for the purpose of advocating minority business enterprise, and more importantly, presenting testimony at public hearings on industry-related topics as they affect minority thrifts. We therefore appreciate the opportunity to provide that input during these oversight hearings on the financial services industry.

At its Sixth Annual Legislative Conference in Washington, D.C. March 27-29, 1985, the American League members adopted the following legislative priorities:

1. Urge the Congress and the Administration to reduce the Federal budget deficit which increases interest rates and threatens homeownership opportunities.
2. Extension of the Net Worth Certificate Program and the emergency thrift acquisition powers. In particular, extend Section 123(C) relating to emergency acquisitions of failing minority thrift institutions (Public Law 97-320).

3. Support some sort of FSLIC premium that is related to risk. However, the standards for determining risk should not discriminate against those minority S&Ls that operate safely and soundly, but in an environment that might be considered risky by those who are unfamiliar with the groups served by minority S&Ls. The interests of FSLIC in reducing the risk of loss of depositors' funds should be balanced against the impact that heavy premium assessments, coupled with the added FSLIC special assessments, and restrictions on growth, have on the bottom line of small, well-run, minority S&Ls.

4. Continue to advocate legislation to provide incentives for savers.

5. Support legislation to close the non-bank bank loophole and establish a Qualified Thrift Lender (QTL) test.

Deregulation versus Re-regulation

Mr. Chairman, since 1980 when the American League began appearing before the Banking Committees of the Senate and House of Representatives, we have been subjected to a myriad to changes that have increased liability costs for S&Ls; helped to ameliorate some of the situations that prohibited thrifts from making money, and finally, attempted to open new avenues to profitability through new powers granted under the Garn-St Germain Act of 1982. These

changes have occurred in a volatile economic environment over which we have little control amidst increasing competition from new, unregulated entrants in the marketplace.

It is not a simple proposition to determine whether deregulation is better than re-regulation, or vice versa. I do not believe that it is a simple choice that will determine the direction of national policy for financial institutions. Looking at the past 5 years, there has been a combination of actions, both legislative and regulatory, that have been taken to address the problems. The next 5 years, which promise industry consolidation and interstate banking, could present serious challenges to the thrift industry as we know it today. Thus, it seems that for the time being, a combination of actions is what is called for.

Net Worth Certificate and Emergency Thrift Acquistions Extension

A 3-year extension of the net worth certificate program, to help those S&Ls that continue to have large percentages of their portfolios in low-yielding, fixed rate, long term mortgages, should be enacted. This authority should be available for those institutions which are well run, but which still need the time to restructure their balance sheets to reduce interest rate sensitivity and rebuild net worth. Although only a few minority S&Ls used

this program in the past 2 years, it should continue to be available to them as they plan for the future.

With regard to emergency thrift acquisitions, we strongly urge that the provision included in Section 123(C) of the Garn St Germain Act be extended. The wording of that section is as follows:

> "In the case of a minority-controlled institution, the corporation shall seek an offer from other minority-controlled institutions before proceeding with the secquence set forth in the preceding paragraph."

This paragraph was proposed by Senator Alan Cranston, who has consistently been sensitive to the unique contribution that minority savings and loans make to their customers and the role they play in the economic development of their communities. The Federal Home Loan Bank Board also adopted guidelines to assure that the minority identity of a failing association would be maintained to the extent possible.

Since the law was placed on the books, there have been several occasions where it was used to preserve the minority identity of troubled S&Ls. On some occasions, merger with a stronger minority institution was accomplished; on others, minority investor groups have been located that have injected the the needed capital to convert a failing S&L into a going concern.

Bank Board Regulations

The net worth regulations and direct investment regulations recently promulgated by the Federal Home Loan Bank Board have focused the attention of the industry on the risks involved with unrestrained growth through costly deposits that are invested in poor quality assets. The lessons of Ohio and Maryland taught us that safety and soundness and the public confidence must be maintained. Therefore, we support a premium that takes into account the risks taken by the management of an institution.

We would caution, however, that a structure that would require approvals of certain activities and restrict others may impair the ability of management to serve a market area whose unique characteristics might be viewed as risky by those who are unfamiliar with it. Some of the lending done in the minority communities could initially be viewed as risky, when in fact it is anything but. These facts would be elicited on examination of the S&L; therefore, they should not be penalized initially with a higher risk premium.

Of especial interest is the proposal by the U.S. League that the management of strong, healthy institutions contract with the FSLIC to resolve problem assets or assist troubled institutions. That proposal has merit, and if implemented as part of an overall strategy to turn around an unprofitable S&L, could have the added benefit of saving the FSLIC fund.

Outlook for the Minority S&L Industry

In 1980, there were 86 minority S&Ls with combined assets of $2.1 billion, a combined net worth of $91.8 million, and 35 stock-owned. By the end of 1983, assets increased to $3.8 billion and net worth rose to $126.8 million. Compared with the previous 4 years, 1984 yielded more opportunities for growth. Assets of the 75 minority-owned S&Ls increased to over $4 billion.

The greatest challenge we see is for the minority S&L to compete within the S&L industry as a whole. To be competitive we must take advantage of technological capabilities and skills of personnel to adapt to the ever-changing, uncertain economy. To do so successfully, we must have the sort of legislative and regulatory framework that does not unduly hamper competitiveness, but instills the confidence of the public in the industry. Whether a combination of these factors will assure success will depend on how well the framework is established and whether it fits the uncertain economy in which it stands.

This concludes my testimony. I will be pleased to answer any questions.

The CHAIRMAN. Thank you very much.

Mr. Brooks, do you believe that the extension of the Net Worth Certificate Program should be tied to a requirement that savings and loans return to GAAP accounting?

RETURN TO GAAP ACCOUNTING

Mr. BROOKS. Return to generally accepted accounting procedures [GAAP] accounting? I think over a period of time, my answer would be affirmative. I think that probably most of them are on GAAP accounting now. We are. But I imagine that some institutions would need time for adjustment. We have come through, as we all know, a particularly trying and terrible ordeal and the fact that so many savings and loans survived attests I think to the strength of the system.

So I believe there's a movement in that direction and that it will happen, but it will take some time.

The CHAIRMAN. Well, we've discussed also bringing net worth equal to bank capital and various periods of time have been floated around. You suggested it takes some time. We talked about 5 to 10 years in some of the testimony.

Is that a proper timeframe?

Mr. BROOKS. I think I can answer, sir, based on my own situation. We are busy restructuring from the low-yield loans we have on our books and we right now feel we are about one-third restructured. We feel that in 2 years we will be two-thirds, and in about a total of 5 years we will be about 85 percent, which I believe is about as close as you can get.

Therefore, it would take us some time. But I certainly believe that capital should be built and as for the 7 years—I don't have a real problem with it. We have that as our goal. Obviously, you can't just turn the thing around right now and say you've got to go to x net worth, but it's a desirable goal. We have to keep in mind a balance of restructuring so that we don't get into this terrible dilemma of fixed low-interest rates in the future as opposed to building net worth. They have got to run together, as I see it, to strengthen the overall industry.

The CHAIRMAN. Mr. Albers, in your statement you refer to studies commissioned by the Federal Savings and Loan Advisory Council which conclude that savings institutions cannot survive long by investing in long-term mortgages.

Would you elaborate a little bit more on those studies and also would it be possible for you to supply the committee with a copy of those studies?

[The study by the Federal Savings and Loan Advisory Council may be found in Senate Banking Committee files.]

Mr. ALBERS. Well, I'm sure the council office can submit the necessary data. What has happened more and more, Senator, since deregulation and deposit deregulation, our deposit liabilities are more and more short and generally floating rates. The money market certificates respond very sensitively to what's happening in the outside rates, the shorter term CD's. When you match up a long-term asset, particularly if it is a fixed-rate asset, you're just asking for

what happened back in the 1930's and what happened back in the early 1980's.

Long-term fixed-rate assets cannot be matched off by relatively short-term nonfixed-rate liabilities.

The adjustable rate mortgage is some relief to this problem. I think the jury is still out on the overall effectiveness of the adjustable rate mortgage. It has not been tested in that first time. If the underwriting is sound, it should come through fine. If the underwriting is somewhat less than sound, I think we will all find out what happens.

The CHAIRMAN. Ms. Chu, you recommend an extension of the Net Worth Certificate Program. As you know, there was an extension contained in S. 2851 that passed the Senate last summer. Some have recommended that there only be an extension of that program if we do go to GAAP accounting.

What is your opinion of tying the two together? And I ask you the same question I did Mr. Brooks as to whether you figure that 5 to 10 years is a reasonable period of time to go to generally accepted accounting procedures?

Ms. CHU. I believe that the industry, Mr. Chairman, has made a very good start with reference to getting back on GAAP accounting as it affects net worth, and given the period of time and the assistance of the net worth certificates it should enable the institutions that have the restructuring problem to be able to do it in a manner where the quality of assets would be better and where there would not be panic and some wrong decisions made.

So in answer to your question, I believe that the 7 years, as indicated by Mr. Brooks, would be a reasonable period of time to tie in the net worth certificates and the GAAP accounting so long as the two are matched up together.

The CHAIRMAN. Given your endorsement and your experience with section 123(c) of Garn-St Germain, would you feel that this should also be applied to minority banks as well as minority savings and loans?

Ms. CHU. Yes, I believe that the section 123(c) should apply also to banks that serve the minority communities that are primarily controlled or owned by minorities.

The CHAIRMAN. Mr. Brooks, would you explain further your recommendation that an experimental risk-based insurance premium be coordinated with the system of variable net worth certificates?

Mr. BROOKS. That the variable risk insurance premium coordinated with the net worth certificates?

The CHAIRMAN. Yes. You recommended that they be.

Mr. BROOKS. No.

The CHAIRMAN. If we go to risk-related premiums, that they be coordinated.

Mr. BROOKS. We think they should be coordinated with the variable net worth requirement. The reason for that, of course, is that an increase in premium represents a hit against the botttom line. Increasing our net worth, however, protects the FSLIC as well as the increase in premium. So we feel that two-tracked approach would be the best way to meet that problem.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

INSOLVENT S&L'S REACH 434 IN 1984

Mr. Brooks, according to Home Loan Bank Board studies, at the end of 1984, there were 434 insolvent savings and loans associations under generally accepted accounting principles. This is out of a total of about 3,200 institutions, with assets of $107 billion or about 10 percent of the industry. The FSLIC experienced about a 15-percent loss on the insolvent institutions that closed in 1984. So FSLIC is faced with potential losses of roughly $15 billion if all of the insolvent savings and loan institutions are closed.

Now if these facts are anywhere near correct, don't we need a massive infusion of new capital into FSLIC? Your recommendations are that we can strengthen FSLIC through better management. That seems to me to be pretty much minor tinkering compared to the magnitude of the problem we face.

Why doesn't the U.S. League support higher premiums into FSLIC?

Mr. BROOKS. Senator Proxmire, if you try to do it with higher premiums alone, particularly with the condition of the industry at this time, I am fearful that it would exacerbate the situation.

We're talking about a combination of the premiums, the building of the net worth of the association, and, in addition, the management expertise that would be available from sources both within and outside of the industry.

Senator PROXMIRE. Let me just interrupt to ask: Why do you think this would be so upsetting if they had an increase in premiums? We're not talking about enormous assessment. We're talking about 1 percent.

Mr. BROOKS. Senator Proxmire, let me say to you, regarding the possibility of an additional increase in premium of one-eighth of 1 percent, and we've already had one-thirty second of 1 percent, this would cause us an extra hit of $240,000 against our bottom line. My association has total assets of $250 million, and as I said, we're trying to restructure and our business plan has called for restructuring as much as we could as long as we didn't show a loss because we felt we had to get ourselves restructured as soon as possible. For our size institution, that is not a small amount. If you would require a massive infusion of premium-generated funds, that really would exacerbate the situation. If you're talking about an infusion of funds of some kind like the 1-percent loan which has been advocated in the past, that would help, but very frankly, that has not been accepted by many of the people both in the business and outside the business, especially in the accounting profession. But we feel that several——

Senator PROXMIRE. That 1-percent increase in investment was advocated by the league. What's wrong with that?

Mr. BROOKS. Well, it was advocated by the league briefly but there were many people that felt this combination approach was better than the investment of the 1 percent in the FSLIC.

Senator PROXMIRE. Well, that seems to me they're kidding themselves.

Mr. BROOKS. Beg pardon?

Senator PROXMIRE. They're kidding themselves. That 1 percent would bring in $10 billion.

Mr. BROOKS. $9 or $10 billion, as I remember, yes.

Senator PROXMIRE. Well, that seems to me to be precisely what we need.

Mr. BROOKS. Well, if that could effectively be put in place it would certainly help. I don't think that alone would solve the problem.

Let me say this: You mentioned all the associations that were—we'll say technically are—insolvent under GAAP accounting. Many of those associations have business plans that will pull them out of it over a period of time, so they won't become a hit against the FSLIC if they have a sound business plan that lets them do the job and restructure.

I know institutions today are doing just that.

Senator PROXMIRE. Well, Mr. Brooks, your capital has been going down—your institutions' capital has been going down over the last 2 years.

Mr. BROOKS. Mine, too.

Senator PROXMIRE. Why do you think if we wait another couple years it will reverse itself and go the other way? It seems to me the momentum is a reduction, not an increase.

Mr. BROOKS. I'm sorry?

Senator PROXMIRE. I say, your capital is going down.

Mr. BROOKS. You're talking about my institution?

Senator PROXMIRE. Not your institution. I mean the institutions you represent.

Mr. BROOKS. Yes. All right.

Senator PROXMIRE. The industry as a whole. The weak ones, the capital is going down, right?

Mr. BROOKS. Well, with some of them the capital is going down.

Senator PROXMIRE. As a whole.

BEGINNING TO RETURN TO PROFITABILITY

Mr. BROOKS. We have begun to return to profitability. We had a good year last year. There are some institutions, of course, that have not shared in this. But it has been a good year. I think it's probably next to the best year we've had since 1978. If we get a reasonable break as far as interest rates are concerned, if inflation can be held down, I can see that this industry will return—the total industry—to its former viability.

Senator PROXMIRE. Well, the capital ratios for the whole industry for 1982 was 3.59, first half; 3.18 for the second half; in 1983, 3.17 and 3.33; in 1984, broken down by quarters, 3.2, 3.0, 2.9, going down, down, down, not up. That's the industry as a whole.

Mr. BROOKS. Senator, it takes a while to turn the *Queen Mary* around and that has not been reflected in the capital—the recent months that we have had to get the capital turned around—but we see that it's beginning to be turned around.

Senator PROXMIRE. The *Queen Mary* is turning in the other direction.

Mr. BROOKS. Beg pardon?

Senator PROXMIRE. The *Queen Mary* is turning the other way.

Mr. BROOKS. No. It takes a while and as far as the profitability is concerned, the bottom line is being enhanced. There's no question

about it. Let me say just one other thing, sir, if I could on the 1 percent infusion. I am told that the accountants said that this would not be an asset. So if the $9 billion—is not an asset it would have to be an expense, of course, and that would be a debacle. And if that's under GAAP accounting, you see, that's the problem we have.

Senator PROXMIRE. Mr. Albers, if your members don't like the thrift test and I take it you don't, why shouldn't they be regulated as a commercial bank with FDIC deposit insurance and subject to the Bank Holding Company Act? What's wrong with that?

Mr. ALBERS. Many of our institutions, Senator, are FDIC insured, the savings bank members of the National Council of Savings Institutions. My own bank is FDIC insured.

I think if the thriftness test were imposed and made law, there is a strong possibility that many of the institutions would convert to commercial banks. If the test has to go in at all, we think it ought to be a bankness test. Let's measure everybody on the commercial lending ability they have. We have no great problem with that.

Senator PROXMIRE. Mr. Brooks, can you provide for the record the number of savings and loan associations and their corresponding assets that do not meet the thrift test under first the House bill as reported by committee, second, the Senate bill as it passed last year; and third, your proposal if enacted into law? I'm asking for that for the record.

Mr. BROOKS. Yes, sir, I'd be glad to.

[The following information was subsequently submitted for the record:]

[Response of the National Council of Savings Institutions to FDIC policy statement and comments to Senator D'Amato may be found on page 1303.]

USL
UNITED STATES LEAGUE of SAVINGS INSTITUTIONS WASHINGTON OFFICE
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August 14, 1985

The Honorable Jake Garn
Chairman
United States Senate
Committee on Banking, Housing
and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Garn:

The U.S. League of Savings Institutions is pleased to respond to the additional questions put forth by you and by Senator Riegle in order to complete the record of your Committee's June 18 hearing on the subject of changes in the financial services industry.

1) How do we preserve the dual banking system if states act too aggressively in permitting an unlimited amount of investment in the name of innovation -- when we realize that "excesses" may well result in losses to the federal insurance system?

The U.S. League long has recognized the benefits of and supported the dual state/federal approach to regulating the thrift industry. Nevertheless, the League has supported the imposition of reasonable federal restrictions on the activities of state institutions. Given the existence of federal deposit insurance, it is impossible to deny the legitimacy of the federal interest in this area. Concerning the impact on the dual system of federal overrides of state empowerments, we doubt that preemptive action of this kind would have any significant impact on the functioning of that system as long as the limits placed on state powers were imposed carefully and selectively on a case-by-case basis.

3) You mentioned a program which permits the FSLIC to take advantage of industry expertise in the management of troubled institutions and their problem assets. Will you describe this program in more detail? Is it being used today? If so, with what success?

The U.S. League has devoted considerable effort to trying to devise means of helping the FSLIC cope with the great stresses that agency has been encountering. One of the most promising approaches to protecting the FSLIC that has been embraced by the League is the Management Sharing Program developed by the League's Task Force on Special Assistance to the FSLIC. The premise upon which the program is based is that, considering the state of the FSLIC fund, the agency's case load, and the tremendous strain that case loan has caused for FSLIC staff, it is essential as a cost-reduction measure that FSLIC begin employing expert industry resources, on a routine basis, to manage problem physical assets and problem institutions.

The key points of the program are as follows:

a. Management of assets

(i) The Federal Home Loan Banks should establish Regional Advisory Committees (RACs) which would help identify experts to be employed in the management of problem physical assets such as buildings and land. There would be one standing RAC per Federal Home Loan Bank district, but more could be established on a case-by-case basis, as needed.

(ii) Each RAC would be made up of the principal supervisory agent (PSA), the state supervisor (where state-chartered institutions were involved), a local FSLIC representative, and a number of representatives from FHLBank member institutions. Industry representatives would be appointed by the PSA, and would receive some form of compensation. RACs would have support staff who would be compensated by the relevant FHLBank.

(iii) RACs would make their recommendations purely on the basis of expertise. There would be no policy against using commercial banks, real estate companies or other types of organizations outside the savings institutions industry.

(iv) The recommendation of a RAC, if accepted by the PSA, would be approved automatically under delegated authority if the amount of assets involved were less than a specified figure.

b. Management of institutions

(i) Because rapid action is essential to the cost-effective resolution of problem cases, the Bank Board should delegate to the FHLBanks as much responsibility as possible for resolving problem cases. Only cases involving a substantive policy issue should require intervention at the Washington, D.C., level.

(ii) The Bank Board should adopt a "consignment" management approach to problem cases under which the FSLIC could use the management expertise of other institutions as a means of minimizing the cost to the FSLIC of resolving problem cases. The choice of a management agent should be the responsibility of the PSA and should be made on the basis of the:

(A) Willingness of management agents to place any capital at risk in the arrangement or to minimize the exposure of the FSLIC;

(B) Management's capacity and track record;

(C) Business plan submitted by each applicant; and,

(D) Structure of management contract compensation, including management fee, right of first refusal in subsequent mergers, transferability of such right, option on assets, branch system, etc.

(iii) In choosing management agents, the PSA should give priority and preference to other savings institutions, but where no institution is interested in such an arrangement on acceptable terms, outside sources of management expertise from the commercial bank sector should be considered.

(iv) Because of the exposure to FSLIC caused by high-risk operating strategies on the part of troubled institutions attempting to recoup losses, institutions coming under a management agent arrangement should be confined in their resuscitatory efforts to prudent practices. In particular, institutions in cases where a management change is contemplated by supervisory authorities should be run strictly according to a business plan. Departure from the plan would require prior PSA approval.

(v) Because of the potential cost savings involved, the Bank Board should consider lowering to $50 million the current informal $100 million minimum savings institution asset size limit for out-of-state resolution of problem cases.

(vi) The Bank Board should substantially improve, within the context of the recommended PSA delegations, the speed of its processing regarding voluntary mergers of weak with healthy institutions and should look favorably on the regulatory forbearances needed to facilitate such transactions. In addition, the regular bidding process for resolution of problem cases should be streamlined as much as possible with a focus on eliminating delays and successive rounds of prolonged rebidding negotiations.

Although the League formally has communicated this program to the Bank Board, we have not yet been apprised of the agency's reaction to it. With regard to the Bank Board's current practices in this area, we know that the agency for some time has been hiring other savings institutions to help it manage problem institutions, but we are not aware of the details of how these arrangements have been structured or how successful they have been.

4) With regard to enforcement powers, the FDIC and the OCC have proposed disclosure of formal administrative cease-and-desist actions against officers of institutions which are slow to respond to informal agreement to modify an institution's activity. Wouldn't this step help insure management cooperation with its regulator?

The U.S. League is strongly opposed to the routine public disclosure of administrative enforcement actions. The recent difficulties of privately insured thrifts in Ohio and Maryland should serve as a stark reminder of the great vulnerability of financial institutions to the effects of adverse publicity. We believe it is highly irresponsible for commercial bank regulators to foster a situation that invites bad publicity, not just for the institution involved in the enforcement action, but for others as well. In terms of whether the threat of publicity will make institutions more willing to follow regulatory direction, we firmly agree with the traditional bank Board view that a general policy of confidentiality enhances enforcement efforts by making targets more willing to consent to orders without litigation. While it is possible that the FDIC/OCC approach might facilitate informal resolution of some individual disputes, we note that this result could be achieved without a blanket disclosure policy simply by selective targeting in appropriate cases. But as a general matter, we seriously question the desirability of policy that would encourage informal resolution of serious cases, thus sacrificing the important procedural advantages flowing from issuance of a formal order.

5) Do you believe that frequency and amount of civil money penalties should be increased?

Current law allows the Bank Board to assess civil money penalties of up to $1000 per day against persons or institutions that have violated final cease-and-desist orders. At this time, we are unaware of a pattern of violation of such orders that would call either for more vigorous use of the civil money penalty device or an increase in the ceiling amount of the fine. On the latter point, we note that the Bank Board in its request for increased enforcement powers has not asked that the $1000 figure be raised.

6) What is your view on prohibiting savings and loans from cross-marketing financial services to customers if those services cannot be offered by a bank holding company? What are the advantages of cross-marketing -- to an institution and to the consumer? Any evidence of abuse?

The U.S. League would oppose strongly any effort to limit savings institutions' ability to cross-market financial services that cannot be offered by bank holding companies. While opponents of tandem operations have decried them as being bad for consumers, competition, and the safety and soundness of the financial system, as well as offering a means whereby savings and loan holding companies can abuse their savings institution subsidiaries, they carefully have dealt only in generalities. There is no record of which we are aware detailing any negative effects that tandem operations may have had.

In point of fact, by making a wider variety of services available to the public at a wider variety of locations, tandem operations would seem beneficial to savings institutions' customers. Certainly they have been beneficial to savings institutions engaged in them, permitting those organizations to add strength to their bottom lines at a time when rebuilding capital is of prime concern to thrifts and their regulators. The League also wishes to stress that the question of how to deal with abuses arising out of affiliate relationships within holding company organizations already is covered by an extensive body of law, including the general corpus of antitrust laws, anti-tying statutes, and provisions of the laws governing S&L holding companies. The notion that new legislation is needed to "protect" savings institutions from being victimized by the tandem operations of their holding companies is particularly baseless -- transactions between savings institutions and such affiliates are very tightly restricted, generally requiring prior Bank Board approval.

In our view, if legislation in the cross-selling area is regarded as necessary, it should avoid blanket bans on the offering of various services and should focus on dealing with specific abuses on a case-by-case basis as determined by the FSLIC. Under the latter approach, those activities determined to be causing such adverse effects as decreased or unfair competition, conflicts of interest, undue concentration of resources or unsound practices would be prohibited, while those not generating negative consequences would be undisturbed.

8) Why should bank and thrift holding companies be given the authority to underwrite and distribute mortgage-backed securities?

Savings institutions are the major source of residential mortgage credit and, to maintain that specialization, should be able to access and serve the entire mortgage capital pool. Realistically, many small institutions could not use such an authority but, as a matter of equity, it should be available. To avoid the problems of economic issue size for these small shops, it would be helpful if jointly-owned savings institutions subsidiaries could exercise this power. In general, these securities authorities should not necessarily be limited to institutions in holding company format since, unlike commercial banks, the majority of our institutions remain mutual in form and, absent the mutual holding company concept, would not be able to use a holding company affiliate for this purpose. Currently commercial banks may underwrite limited types of securities directly: this precedent should be considered.

9) In his testimony, Doug immerman of Anchor Savings and Loan believed that affiliating with a realtor was a natural progression for his company. Do you believe a federal savings and loan should be given the same authority? Why?

Third party real estate brokerage is a natural fit with the real estate finance function. Many real estate brokerage operations are already linked to or owned by mortgage banking operations. Portfolio lenders can access all of the financing options available in the secondary market and in addition can tailor special products for their own peculiar investment needs. Consequently, such an integration could provide added choices and efficiencies to the real estate market. The strict separation between real estate brokerage and finance has already been branched by major Wall Street and retailing operations. Savings institutions should be given that same business opportunity to better serve their customer base.

10) What percentage of your association's member institutions would not qualify under the qualified thrift lender test contained in S. 2851? In H.R. 20? What changes, if any, would you recommend to the thrift lender test of last year's Senate bill? Why?

The exact percentage which would fail would depend on the technical language interpreting the statute but we are concerned at the number of institutions which would fail under either the Senate or House approach. Under the Senate version, as many as 354 institutions, 10.6% of our institutions by number holding 17.8% of the assets of our business would fail to qualify. Under H.R. 20, as many as 666 of our institutions, 19.9% of the total number, would fail and these institutions hold 25.5% of the assets of our business. (All these numbers are based on the FSLIC-insured universe--the House bill would actually exempt savings banks from the qualified thrift lender test unless subsequently taken over by an outside holding company.)

We do feel that even the more liberal Senate version could be improved by a separation of the mortgage banking and liquidity credits against the qualifying asset percentage. To avoid a "money fund" format, perhaps a total cap on liquidity items would be appropriate but the present combined Senate 10% cap on mortgage banking/liquidity qualification does not even cover the typical, prudential holdings of the average savings institution. It is not difficult to draw a line between banks and savings institutions -- we would like to cooperate in that effort.

11) The comment has been heard from many quarters of the need to restructure FSLIC to be sure that it will continue to have the confidence of depositors it insures. Would you comment on the form this restructuring should take?

As we stated in our testimony, we believe the legal framework governing the Federal Savings and Loan Insurance Corporation and its parent Federal Home Loan Bank Board should be altered to enable them to hire, fire, and compensate their staff on a competitive, businesslike basis. Unlike the commercial bank regulatory agencies, the FHLBB/FSLIC organization has been subject to essentially standard federal agency personnel and budgetary constraints, which have proved

highly counterproductive in terms of their impact on our regulator's ability to respond flexibly to the great challenges confronting our business. We realize that a restructured FHLBB/FSLIC would cost more, and that our industry would have to shoulder the burden of this expense, but we are confident that in the end the restructuring would pay high dividends in terms of assuring efficient, effective regulation. The U.S. League currently is drafting legislation embodying our regulatory restructuring goals, and we expect to be in a position to transmit a draft bill to you shortly.

12) You and Mr. Albers recommend that the net worth certificate program be extended, but make the recommendation without mentioning any definitive benefits of the program to date. The General Accounting Office is reviewing the net worth certificate program among other aspects of the thrift industry, and while their review is not yet complete, the topline is there are more real misgivings as to the participation level and the effectiveness of the program. Please comment in a more specific manner. Also, given the Federal Home Loan Bank Board has the capability to issue income capital certificates -- and in fact does this -- can this not serve as a substitute for the net worth certificate program? Should the Congress address the issuance of income capital certificates?

The U.S. League strongly urges the Congress to extend the net worth certificate program due to expire in October of this year. It is only in the last few months that interest rates have declined to a level that affords a real opportunity for the business to restructure and it will take some years before the majority of savings institutions will be in a position to live through a period of high interest rates without suffering significant losses.

If interest rates remain low, the net worth certificate program would be relatively costless. If rates were to increase sharply, the certificate program would be an inexpensive way of helping the business weather the high rate period. If the program were allowed to expire, it would take time for Congress to reenact were it needed and the crisis atmosphere that such an effort would entail would further undermine a public confidence that has already been eroded by the difficulties at some large financial institutions and the problems with some of the state savings institution insurance funds.

So far, 94 FSLIC-insured savings institutions have participated in the program and the FSLIC has purchased a total of $129.6 million in net worth certificates. At this stage, no "real money" has been spent in the program since there is no cash involved in the transaction unless an institution has to be liquidated.

Of the 94 institutions, the League's Research Department has been able to identify 89 on the FHLBB's quarterly-report databank -- the others having merged out of existence. The 89 institutions had total assets of $23 billion at the end of last year. If these institutions had to be liquidated instead of being supported by the net worth certificate program, the total cost would have been $3.7 billion, using the 16%-of-assets cost figure that is frequently used in such instances. Given the fact that the FSLIC had total reserves of only $6.9 billion at the end of last year, $3.7 billion is an impressively large figure.

The number of institutions using the program is small but there are particular reasons why more did not elect to participate.

The Bank Board in office when the program was instituted was inimical to it. The general counsel for the Board at the time is quoted by the General Accounting Office as saying:

> "There should be every incentive for institutions not to participate in the program, or if they do . . . to graduate from it as quickly as possible. Therefore, participants should expect a certain degree of increased regulatory restraints and general operating discomforts."

At least in the beginning, the Bank Board made it difficult for institutions to participate. In particular, in the first four months after it started the program, the Board received 95 applications but only acted on 13 of them -- and of those, only four were approved and the others were either withdrawn or denied. Since interest rates were declining and conditions were beginning to improve in the industry, thereby reducing the need for institutions to get involved, the early delays were probably extremely important in keeping the number of participating institutions at a low level.

The processing delays resulted from two of the Bank Board's administrative requirements -- approval of institutions' appraised equity capital and submission of business plans as conditions of assistance. Neither of these requirements were set as conditions by the statute. According to a 1984 GAO report:

> "When institutions first began submitting required property appraisals, . . . Federal Home Loan banks began rejecting them for technical reasons. Some appraisals were rejected because they did not reflect highest market value according to Bank Board criteria; some applications were delayed because of confusion about when business plans were required -- before or after assistance was granted -- and about their content."

In addition to being an administrative headache, the requirement to recognize appraised equity capital before an institution was allowed to issue net worth certificates disqualified 125 institutions according to GAO estimates because it took them over the threshold 3% net worth ratio.

Furthermore, the Bank Board, in the beginning, was more miserly than the FDIC in the amount of assistance it would grant. When an institution first entered the program the Board would purchase only half of the certificates the institution was entitled to under the statute.

Also the act suggests that the agencies cover 70%, 60% or 50% of an institution's losses depending on whether the institution had a 1%, 2% or 3% net worth ratio, respectively. The Bank Board interpreted this to mean that it would first cover 70% of the losses up to the point at which it would bring the net worth, after assistance, to 1%. Then it would cover 60% of any remaining losses until the net worth ratio reached 2%. Finally, it would cover any more losses at 50% but only up to the point where the institution's net worth reached 3%.

According to the GAO, the Bank Board's assistance formula:

> "compared to the assistance allowed by the act's formula and available under FDIC's program, tended to decrease the amount of assistance available to qualified institutions. The act does not provide for the tiering calculation, nor for capping assistance at 3 percent net worth. FDIC, while capping assistance at 3 percent net worth level, does not use a tiering calculation when determining assistance amounts."

Under the chairmanship of Edwin Gray, the Federal Home Loan Bank Board liberalized the program. In September 1984, the Board eliminated the reduced initial assistance formula and the tiering calculation. The new formula provides for assistance at the maximum 70% suggested by the act with a cap at the 3%-of-assets net worth level.

In a new July 1985 report, the GAO found that the Bank Board and the FDIC were operating the programs in a manner that followed the intent of Congress:

> "We saw no indications of either agency departing from established statutory and regulatory eligibility criteria. Thus, we concluded that each agency was consistently applying its own eligibility requirements in granting thrifts net worth certificate assistance."

In the July report, the GAO pointed out that institutions that are receiving net worth certificates continued to lose money in 1984 while the business as a whole was profitable. The business, in the aggregate, was profitable in 1984, though only barely so. The return on assets for the year was only 0.14% and almost one-third of the industry was still losing money in the first quarter of 1985. Thus, it should not be surprising that institutions that were weak enough to qualify for assistance in the first place were still showing losses in 1984. Furthermore, the 89 institutions that we have been able to trace made considerable progress in reducing their loss levels throughout the year. The aggregate annualized quarterly return on assets was as follows:

First Quarter, 1984	-0.80%
Second Quarter, 1984	-0.32%
Third Quarter, 1984	-0.59%
Fourth Quarter, 1984	-0.28%

Also 14 of the 89 institutions made money in the first quarter last year and, by the fourth quarter, 31 were in the black.

For the business as a whole, our preliminary results show that the second quarter of 1985 showed a strong pick-up in profitability levels. We would suggest that the second quarter results are the ones to look at for the institutions that are in the net worth certificate program if one is trying to determine their ability to return to profitability.

In May of 1985, the GAO released, without comment, a series of tables comparing institutions that have received net worth certificates with the business as a whole. One of these tables shows that the portion of assets in the form of fixed rate mortgages fell from 77.0% to 61.3% between December 1982 and September 1984 for those institutions receiving assistance. This decline of 15.7 percentage points compares with a decline of 18.9 percentage points for the business as a whole, where fixed rate mortgages fell from 72.1% to 53.2%.

Similarly, the percentage of assets in the form of ARMs for assisted institutions rose from 3.2% to 17.2% compared to a rise from 6.8% to 21.9% for all institutions. Although the GAO does not explicitly say so, one presumes that these figures are presented to show that institutions receiving net worth certificates are making less progress towards restructuring than the average institution. Again, these findings are not surprising. Many of the assisted institutions are located in areas where the real estate market is not as buoyant as in other areas and the fact that they have made only a little bit less progress in restructuring than the rest of the business argues on behalf of the continuation of the program.

In sum, we strongly urge the Congress to renew the program. It gives the regulators additional flexibility in dealing with problems, particularly the problems that would arise if interest rates were to climb again. It does not reduce the regulators' authority and flexibility in disposing of problem cases if the opportunity to do so exists. In fact, one of the explicit requirements of the Bank Board that must be met before an institution can issue net worth certificates is that a merger that would reduce the need for assistance is not available.

With respect to the possibility of substituting use of income capital certificates for the net worth certificate program, the Bank Board would have considerable flexibility to employ ICCs under 12 U.S.C. 1729(f)(1), which allows the FSLIC to make, inter alia, loans or contributions to insured institutions (1) to prevent their default, (2) to restore them to normal operation if they are in default or (3) to lessen the risk to the FSLIC where the agency determines that severe financial conditions exist threatening the stability of a significant number of insured institutions or of insured institutions possessing significant resources. For a variety of reasons, however, we believe that renewal of the net worth certificate program would be a far superior approach to assisting well-run but financially troubled institutions than would reliance upon section 1729(f)(1) authority.

First, unlike section 1729(f)(1) assistance, which must be bottomed on subjective determinations regarding the possibility of default or recovery therefrom or the existence of "severe" financial conditions, net worth certificates basically may be provided to any institution with net worth of 3% or less that is suffering operating losses. Thus, net worth certificates potentially are available to a wider variety of institutions than are ICCs, and eligibility is far easier to determine.

Second, without the renewal of the net worth certificate legislation, there would be no barrier to conditioning grants of assistance to any institution upon agreements to merge or change management. Current law governing the program specifies that such conditions may not be imposed where the FSLIC determines that the recipient institution has, with regard to mergers, more than 6 months left of positive net worth, or in the case of management changes, more than 9 months.

Third, present law specifies that net worth certificates may be counted as capital regardless of any statutory or regulatory obstacles. Similarly, the existing net worth certificate statute also overrides any state laws that would interfere with an institution's ability to take part in the net worth certificate program. If the legislative underpinnings of the program were permitted to lapse, many state-chartered institutions would find participation in any ICC assistance plan impractical or even illegal because of the lack of a federal override regarding section 1729(f)(1) assistance.

Fourth, to assure that federal assistance is not diverted to local or state government authorities, current law states that, while an institution has net worth certificates outstanding, it shall not be liable for any tax based on deposits held or the interest or dividends paid on those deposits. Again, lapse of the program would mean the end of this protection, thus, in effect, leading, should the FSLIC embark upon a substitute assistance plan employing ICCs, to an unjustified diversion of FSLIC funds from insured institutions to state and local governments.

Finally, without the net worth certificate legislation, the FSLIC would have no authority whatsoever to provide assistance to institutions insured by private funds. Current law allows such aid, subject to certain requirements pertaining to assessment levels and indemnification.

Accordingly, in our view, the ICC approach would be a very imperfect substitute for the net worth certificate program. We are convinced that Congress should act to assure continued availability of NWCs, rather than tinker with the FSLIC's ability to issue ICCs.

13) The Committee continues to hear concerns voiced over the proliferation in the investment in high-yielding/high-risk bonds, the so-called "junk bonds." Do you feel investment in high-yield bonds is a current or potential problem to the thrift industry, and should in fact any restrictions or legislative action be considered?

In our view, there is no need for any Congressional action with regard to the ability of thrift institutions to invest in so-called "junk" bonds, except to the extent the Bank Board may need clarification of the scope of its authority to regulate such investments by state-chartered institutions. From a regulatory standpoint, an investment in a risky corporate debt obligation should be regarded no differently than an investment in a risky commercial loan -- they both should be permitted as long as the institution has underwritten the risk properly and does not concentrate too much of its resources in the area. In terms of overall thrift risk exposure through investments in high-yield instruments, our industry currently has a negligible amount of its assets committed in this manner, although some individual institutions have invested quite extensively in junk bonds.

QUESTIONS FROM SENATOR RIEGLE

1) In your testimony you point out the many differences between savings institutions and commercial banks. I happen to be a great believer in the traditional role of thrift institutions being the primary providers of financing for residential housing. But more and more I hear that with the problems facing savings and loan institutions today, there is an inevitable merging and consolidation of commercial and thrift functions taking place.

1) To what extent do you think S&Ls should remain separate entities serving primarily the residential housing needs of homebuyers?

Homeownership historically has been one of the strongest American aspirations and is likely to remain so. Public support for policies facilitating homeownership is thus also extremely likely to continue. Accordingly, the nation should not see any significant change in the demand for a steady supply of home mortgage credit, which is the central policy rationale for the existence of a separate thrift industry.

In terms of the degree to which thrifts should be compelled to remain focused on housing, we recognize that certain benefits accorded savings institutions to help them accomplish their housing promotion mission -- access to FHLBank long-term advances, unitary S&L holding company activities flexibility and so forth -- should be removed from institutions that stray too far from a housing specialization. We note that current law already accomplishes this in the holding company area through use of the 60%-qualifying-assets test found at section 7701(a)(19)(C) of the Internal Revenue Code. In our view, it would make more sense to deal with possible housing de-specialization situations in this manner than by establishing a mandatory level of housing commitment for all thrifts. As a practical matter, the vast majority of thrifts will continue to adhere to their housing specialization because it is their area of greatest expertise, and we doubt any useful purpose would be served by interfering with the investment strategies of the relatively small number of institutions that, because of local market conditions or for other reasons, wish to deviate significantly from the home mortgage path.

2) To what extent do you believe thrifts should be encouraged to become one-stop financial shopping centers?

With respect to the one-stop financial shopping center issue, it clearly is desirable for an institution to have the ability to offer under one roof as many financial services as feasible. The actual decision of whether to offer such a variety of services, of course, is one that only can be answered by reference to the variables -- personnel expertise, geographic location, competitive situation and so on -- affecting each individual institution. While we believe it would be a very positive step for Congress to increase the number of financial services thrifts and other depositories may offer, we believe that active regulatory encouragement of use of the one-stop option would be inappropriate, for it inevitably would not be a profitable business strategy for some institutions.

3) How do you respond to those who say that there are so many serious problems facing thrifts today that the only reasonable thing for us to do at this point is to give them additional power and enable them to become more like commercial banks?

The central economic problem facing savings institutions today remains that of our portfolios of low-yield, fixed-rate mortgages, which over the past several years have severely reduced our earnings and, consequently, our net worth position. Once this negative legacy is disposed of, however, there appears to be no reason why our industry should not regain strength while pursuing its traditional housing specialty. Although one can not gainsay the merits of affording our institutions additional investment flexibility as a means of facilitating the strength-rebuilding process, it would be extremely far-fetched to regard the provision of additional commercial-banking-style powers as a panacea for the problems we have encountered as the result of our past commitment to long-term, fixed-rate lending.

4) What do you think your industry will look like five years from now?

It is doubtful that there will be dramatic changes in the investment focus of our industry over the next five years. Real estate -- especially residential real estate finance -- will remain our field of specialization. Certainly, more institutions will be involved in commercial and consumer lending, but I doubt that the expansion of these investment categories will be such as to affect significantly the commitment of our business to housing.

5) What assistance, if any, do you think Congress should provide the S&L industry at this time?

As we have emphasized in our written statement, we believe it is important that Congress extend the net worth certificate program authorized by Title II of the Garn-St Germain Act. That program, which currently is scheduled to expire on October 15, 1985, has great potential for allowing well-run victims of the low-yield mortgage trap to work their way out of their problems with no ultimate cost to the FSLIC -- a result which also, of course, would be of benefit to that agency. Moreover, as we further testified, it would be quite beneficial from the standpoint of saving money for the FSLIC for Congress to extend the emergency acquisitions provisions found at section 123 of the Garn-St Germain Act. Finally, it also would be most helpful if Congress would authorize an increase from 3% to 5% in the percentage of their assets that federal associations are allowed to invest in their service corporations. These subsidiaries have become important profit centers for savings institutions, and by, allowing a higher level of investment in them, Congress would be contributing importantly to restoring our industry's health.

You will note that we have not responded to your questions #2 and #7. The first #2, relates to the strength of unitary savings and loan associations, the potential effect of a qualified thrift lender test upon them, and the impact upon them of restrictions on tandem operations. The second question, #7, deals with the ability of savings institutions which sell mortgages in the secondary market to meet a qualified thrift lender test. Unfortunately, a serious illness in the family of a member of our Research Department whose area of expertise this is has delayed an accurate response to these questions. We apologize for this delay and respectfully request we be permitted to forward our responses to questions #2 and #7 within one week.

On behalf of our 3,500 member institutions, thank you for this opportunity to expand upon our previous testimony.

Sincerely,

Edwin B. Brooks, Jr.

Edwin B. Brooks, Jr.
Legislative Committee Chairman

cc: Senator Riegle

Senator PROXMIRE. Mr. Albers and then Mr. Brooks, the GAO record of the financial solvency of the institutions receiving net worth assistance is getting worse, not better. If net worth certificates are not helping, why should the program be extended?

Mr. ALBERS. Which one of us first?

Senator PROXMIRE. Mr. Albers first and then Mr. Brooks.

Mr. ALBERS. Well, I think in the term of rate environment that we're in, rates have been dropping rather sharply for the past few months, the short-term outlook for the industry certainly is better than it has been in a long time. Time is an asset to an institution. If you're under GAAP accounting, as several of our members are, you cannot take advantage of the restructuring as much as ones under the other type accounting. I think if an institution has a strategic plan filed with the regulators that makes sense then that institution should be permitted to continue along the path and try to bring itself out. If, however, the strategic plan would indicate nothing much happening or more chaos, then I think it's an open question.

Senator PROXMIRE. Mr. Albers, let me give you the record. The record I think is just overwhelmingly negative. During 1979 the last quarter, net worth according to GAO was 4.94. In 1980, first half, 4.7. Second half was 4.4. Then it dropped down in 1981 to 3.7, second half at 2.08. Then it dropped down to 0.43 in the first half of 1982, the second half was negative 1.25. Then the negatives keep increasing—1.73, 2.2, 2.45, 2.67, 2.80—right through 1984. It's getting worse and worse and worse. These are the ones getting net worth certificates.

Mr. ALBERS. I understand. We have been in a very hostile rate climate in the time period you have cited. The short range in the past few months and perhaps foreseeable balance of this year and into next year will look more favorable.

Senator PROXMIRE. Well, interest rates are coming down. They came down in 1983 and 1984 and the situation is still getting worse and worse.

Mr. ALBERS. Yes. What I originally said was this, if they have filed a strategic plan that would indicate they could bail themselves out with reasonable certitude, then they should be permitted to continue to try that. If, however, the strategic plan would indicate they can't do it, then I think we have a very real problem that should be solved other than with net worth certificates.

Senator PROXMIRE. Mr. Brooks.

Mr. BROOKS. First of all, Senator, the U.S. league has been seeking a copy of that report and so far has been unsuccessful. I think it would be very helpful if we could see it.

As Mr. Albers has said, in 1983 and 1984, of course, interest rates didn't come down anything like they have in the very recent months. They did come down some and then they kicked back up, if you recall, and we were all concerned again. Now they are down more than they have been for several years. So that factor, by itself, over a period of time, should help the situation.

Now the strategic plan that Mr. Albers mentioned, I'd like to emphasize that we're talking about a long-term strategic plan. Now that's not a plan that's just put together superficially. It's put together to show that this institution can survive under certain sce-

narios and this is filed with the Federal Home Loan Bank Board and they go over it with a fine-toothed comb. With that sort of plan, why not continue the assistance, which would certainly save the FSLIC a lot of money over time?

ORDERLY TRANSITION OF NATIONWIDE BANKING

Senator PROXMIRE. Let me ask Mr. Albers on another subject, on page 3 of your statement, you argue for an orderly transition of nationwide banking.

Mr. ALBERS. Right.

Senator PROXMIRE. Are you suggesting that unless we approve nationwide banking we should have no bill at all?

Mr. ALBERS. No, I'm not suggesting that. I think the other provisions in the bill are decidedly to the benefit of the financial institutions. In general terms, Senator, the National Council of Savings Institutions is procompetitive. In that overall context we would also be supportive of nationwide banking.

Senator PROXMIRE. The reason I asked that is because on page 3, your last sentence in that paragraph, says:

> Our reading of the political winds tells us that such a goal is getting harder and harder and may be far from the minds of many Members of Congress

that is, nationwide banking——

> If indeed this is the case then in our opinion no legislation is better—far better—than regressive legislation.

Now you tell me that you don't really mean that. I'll repeat that. You say——

Mr. ALBERS. I heard you. You do not need to repeat it.

Senator PROXMIRE. Which is right, what you said in your prepared statement or what you're telling me now?

Mr. ALBERS. All right. Let me say—it is my own opinion that nationwide banking per se would not negate the other benefits in the bill. The testimony you read back or the written record is, I think, a little broader than one single issue, to be honest with you. The strongest issue with the National Council of Savings Institutions is not nationwide banking. That is not our No. 1 priority.

What we are looking for are broader powers, real estate, investment, and the like. So I think when we say no bill is better than, we're not tying that to any one issue.

Senator PROXMIRE. I appreciate that. That's very helpful.

Mr. ALBERS. Thank you.

Senator PROXMIRE. One other question. Mr. Albers, would you favor expanding the NOW account authority to allow banks and thrifts to offer NOW accounts to business customers?

Mr. ALBERS. Yes, I would.

Senator PROXMIRE. Would you, Mr. Brooks?

Mr. BROOKS. Yes.

Senator PROXMIRE. I do have one more question, Mr. Chairman.

A recent study by the California Association of Realtors reports cases where lenders have overcharged mortgage borrowers in calculating rate adjustments under an ARM loan. For example, the association's general counsel received a rate increase of $120 a month when it should have been only $30.

Are your members getting complaints about ARM rate adjustments and do you see any need for action to prevent overcharging in the future?

Mr. BROOKS. Senator Proxmire, I am not aware of our organization getting any complaints in this area. I go back to the time that I spent testifying before you on all the RESPA legislation and all of that, when you had cases that were just awful. But I can't believe that this entire industry is doing that.

I think the regulatory authorities can deal with the situation. Of course, the study is there and I haven't seen the study and I don't know anything about it, but I don't believe that this is a general trend. I don't believe right now that it is of such magnitude that it cannot be handled by the regulators.

Senator PROXMIRE. Well, I appreciate that. I hope you're sensitive to that because, as I say, in this case the association general counsel got a rate increase and he, of course, was a professional. He was in a position to act. The general public, by and large, when they get that kind of charge is not as aware or as informed as a professional would be.

Mr. BROOKS. If an institution is interested in building a business—and I've been building mine for 31 years—it's going to try to do the right thing by its customers and keep its image in its community. We are a local home financing institution and we intend to stay that way. We certainly would not engage in something like that and I believe I represent the broad majority of my membership.

Senator PROXMIRE. Thank you, sir. Thank you, Mr. Chairman.

The CHAIRMAN. Ms. Chu, you mentioned your concern that assessing risk-based insurance premiums to some activities of minority S&L's might mistakenly be treated as risky. What specific activities were you referring to?

MIXED USE OF REAL ESTATE

Ms. CHU. Mr. Chairman, for instance, in many instances the customers of the minority savings and loans have different priorities as to where their funds are being expended. For instance, in many of the minority communities home ownership is a priority and the tests that are generally used to determine whether or not there is credit worthiness or whether there is the ability to repay may be understated as it relates to the minority customers.

In other instances, the minorities may be engaging in different kinds of residential real estate which may involve a mixed use. That is not uncommon in the lower middle income minority groups.

Generally speaking, the mixed use of residential combined with either commercial or retail use has not been favored as a favored kind of real estate investment in terms of home ownership and yet that is peculiar to many minority groups.

Those are only two of some of the examples.

The CHAIRMAN. Thank you very much.

We appreciate each of you being here and your willingness to testify today.

Next I'd like to invite to the witness table Mr. Kent Colton, executive vice president, National Association of Home Builders; and Mr. Robert J. Spiller, chairman and chief executive officer of Boston Five Cents Savings Bank.

Mr. Colton, would you like to begin?

STATEMENT OF KENT COLTON, EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. COLTON. I would be delighted. Mr. Chairman, my name is Kent Colton. I am executive vice president and chief executive officer of the National Association of Home Builders. I am testifying on behalf of the more than 133,000 members of the NAHB.

On a personal note, I would like to say that it's an honor for the first time to testify before my Senator from Utah and to congratulate you on your strong leadership in the housing and financial institution area.

As we begin legislative considerations in this Congress related to the financial services industry, Mr. Chairman, I would like to commend you and the other members of this committee on the legislation which was passed overwhelmingly in the Senate on this topic last year, S. 2851. That bill represented a sensible approach and I would add a reasonable compromise to correct current inequities in the financial services industry, while protecting the safety and soundness of the financial system. And there's obviously a delicate balance in those two areas. In fact, NAHB would like to see similar provisions enacted into legislation this year.

IMPORTANCE OF FOUR FACETS OF S. 2851

Among other items, there were four facets of S. 2851 which were particularly important to housing and housing related finance.

First, thrift institutions and commercial banks were given the authority to underwrite mortgage-backed securities.

Second, commercial banks were not provided with expanded investment powers relating to real estate.

Third, nonbank bank loopholes were closed, and finally, an appropriate thriftness test was included in the bill in order to encourage residential investment by thrifts.

NAHB's position has essentially not changed since last year's presentation. In fact, we feel recent events like the ones which occurred in Ohio and Maryland have substantiated the need to move carefully regarding the financial services industry and they have reinforced the need to limit the expansion of direct real estate development investment authority.

While Congress has not granted new powers for banks or bank holding companies, the lack of Federal legislation dealing with expanded powers has left the door wide open for State legislatures to grant broad investment authority to State-chartered institutions. In many States, these authorities are already more liberal than the legislative proposals which were considered last year and rejected by this committee.

Let me be clear; broad, direct investment authority in real estate for financial institutions involves substantial risks for Federal insurance funds.

We applaud the recent regulatory efforts by the Federal Home Loan Bank Board to limit the investment authority for State-chartered institutions and we have encouraged similar efforts by the FDIC and the Federal Reserve.

With that said, Mr. Chairman, I hope the committee will follow the legislative proposals for expanded powers which were in last year's legislation and not grant additional authority to federally chartered institutions in direct real estate equity investments.

In fact, we were pleased to note that the administration has revised their position in this area when Mr. Baker testified.

On the other hand, the new powers recommended for banks and thrift institutions to issue, underwrite, and market mortgage-backed securities would be beneficial to housing and to the financial institutions.

An increasing number of mortgages are being placed in securities and sold in the secondary market. By the end of 1984, there were nearly $300 billion outstanding mortgages in mortgage passthroughs. Even more remarkable, more than half of these passthrough securities were issued in the 2 years of 1983 and 1984.

Allowing banks and thrifts to participate in this aspect of mortgage finance would assist potential home buyers by providing a greater supply of affordable mortgage credit. In fact, as we noted in a letter to you, Mr. Chairman, which we sent last year, a copy of which is attached to our testimony, this power will be especially helpful in local or regional markets if smaller institutions are able to package, issue, and underwrite mortgages in the form of securities. Such securities could be sold to specialized investors such as State or local pension funds or insurance companies and would facilitate the private sector flow to housing in these more local markets.

As a final point, Mr. Chairman, I would like to comment on the thrift asset test. Although some broad asset powers were definitely necessary for thrift institutions during times of financial stress of the early 1980's and in fact were enacted into law by this committee, we can foresee a serious consequence in the volume of home mortgage lending if thrifts drift completely away from their traditional role as major suppliers for mortgage credit. However, we do not see this happening in the future.

Therefore, NAHB does support a strong thrift asset test which will maintain the thrift commitment to residential home lending.

Currently the Savings and Loan Holding Company Act defines two types of holding companies—the unitary holding company and the multiple holding company. Restrictions are placed on multiple holding companies but unitaries may be exempt from these restrictions as long as their subsidiary is a qualified building and loan according to IRS rules.

We therefore feel the subsidiary should be subjected to a stricter asset test.

S. 2851 provided for a qualified thrift lender test which we would like to see offered again in this year's legislation. In general, we were pleased with the test included in last year's Senate bill which provided a limited amount of originations and prohibited Federal Home Loan Bank advances for thrift institutions not in compliance with the test.

We would be happy, quite frankly, with the same test. We are aware, however, that there has been some discussion over the assets which would qualify toward the test and the percent of assets that should be required. Should the dialog be reopened on this topic, we would like to take part in any additional discussions.

In designing the thriftness test there are three major areas involved—the percent of assets required to be invested, the assets eligible for the required pool, and the penalties for not qualifying.

Naturally, there are tradeoffs among these three but in general we feel that a strong test will maintain the thrift commitment to home mortgage lending and we would like to work toward this end.

In closing, I would like to reiterate NAHB's support of last year's legislation. We feel the changes addressed in S. 2851 were important considerations which need to be decided by the Congress and not the courts and we would like to see similar provisions enacted into law this year. Rapid action is essential and we would urge you to move as quickly as possible on this matter.

Thank you very much for the opportunity to comment and I would obviously be delighted to answer any questions that the committee would have.

[The complete prepared statement, letters, and summary of NAHB tax reform proposals affecting housing follow:]

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

U.S. SENATE

on

FINANCIAL SERVICES INDUSTRY

June 18, 1985

Mr. Chairman and Members of the Committee:

My name is Kent Colton and I am Executive Vice President and Chief Executive Officer of the National Association of Home Builders. I am testifying on behalf of the more than 133,000 members of The National Association of Home Builders. I would like to thank you for the opportunity to appear before your Committee and testify on the financial services industry.

INTRODUCTION

Last year NAHB testified before the Senate Banking Committee on this same issue. Our position has essentially not changed since last year's presentation. In fact, we feel the recent events in Ohio and Maryland have substantiated a need to move carefully regarding the financial services industry and reinforced the need to limit the expansion of direct real estate development investment authority. The adverse effects of excessive high risk investments for banks and savings and loans have not been narrowly confined to those two states.

As we have witnessed, insolvency of one institution sends tremors throughout the entire industry. Similar vibrations were felt with Continental Illinois, Penn Square Bank, Empire Savings and Loan and others. We venture that further stress on the financial system through well-publicized failures could have serious consequences on the federal insurance agencies and the economy.

With that said, I would like to commend you, Mr. Chairman, and other members of your Committee on the legislation which passed overwhelming in the Senate last year, S.2851. That bill represented a sensible approach, and, I would add, a reasonable compromise to correcting current inequities in the financial services industry while protecting the safety and soundness of the financial system. In fact, NAHB would like to see those same provisions offered in legislation this year.

Nonbank Banks and Expanded Powers

NAHB feels the new powers recommended for banks and thrift institutions to issue, underwrite and market mortgage-backed securities would be beneficial to the housing industry and help financial institutions. An increasing number of mortgages are being placed in securities and sold in the secondary market. In 1983-1984, $280 billion in mortgages were sold, and $155 billion were in new pass-through securities.

By the end of 1984 there were nearly $300 billion outstanding in mortgage pass-throughs -- which means more than half of the pass-through securities were issued in those two years. Allowing banks and thrifts to participate in this aspect of mortgage finance would assist potential home buyers by providing a greater supply of affordable mortgage credit. My testimony includes copies of letters supporting the Senate Banking Committee's position last year on mortgage backed securities and on the Senate bill (Attachments A, B, and C).

I would encourage you to act quickly on new legislation since the situations which existed last year remain unresolved. It does not appear that certain issues such as the nonbank bank loophole or discrepancies between state-chartered and federally-chartered institutions are self-correcting in the market place. In fact, NAHB views some of the solutions occurring on a state-by-state basis as worse than the original problem.

The competitive disadvantage to National and State banks resulting from "loophole banks" or from differences between state chartered and federally chartered institutions is far reaching. Among other things, failure to close loopholes in current banking laws has heightened banks' demands for new powers. While Congress has not granted new investment authorities to banks or bank holding companies (BHC's), the lack of legislation dealing with expanded powers has left the

door wide open for state legislatures to grant broad investment authority to state-chartered institutions. In many states, these authorities are already more liberal than the legislative proposals which were considered last year and rejected by this Committee. This is particularly true for real estate investment authorities.

Concentration of resources is an additional concern if overall banking legislation is not passed. Both bank holding companies and financial services firms will have the ability to increase their assets and expand their holdings through insured deposits of nonbank banks.

Many nonbank holding companies such as Sears, Merrill Lynch and Shearson/American Express already control a tremendous amount of economic assets in their own right, and their nonbank banks permit them direct access to consumer and commercial deposits as an additional source of funds. Such economic concentration severely threatens the small independent bank, particularly in rural communities.

Certainly there is no way to foresee the total economic impact of chartering numerous nonbank banks. But even a conservative view at this time raises serious questions. NAHB urges the Committee to consider legislative proposals to close the nonbank bank loophole.

REAL ESTATE INVESTMENT

As I go on to another subject I would like to quote part of an article which was printed in the June 1985 issue of Mortgage Banking, a publication of the Mortgage Bankers Association.

The article says, "The developers of the future are going to be banks and savings and loan associations. Small developers are encountering the same problems that had drastically reduced the numbers of small farmers and corner grocers in the past. As financial institutions fill the gap left by inefficient developers, they are learning the development profession by trial and error."

Our argument is not to protect the inefficient developers. Real estate acquired through default on a construction project is as much a problem for the financial institution as it is for the building industry and the economy. Rather, we feel the problem lies in real estate development as an attractive new source of profit for financial institutions. This new source of profit brings with it a high risk of loss.

We applaud the recent regulation finalized this year by the FHLBB. The regulation reflects a concern that broad direct investment authority for state-chartered institutions involves substantial risk for the FSLIC. The FHLBB rule addresses the maximum amount that a federally insured thrift

can invest directly in real estate, equities and service corporation subsidiaries without prior approval of the principal supervisory agent. Those federally-insured, state-chartered S&Ls meeting minimum capital requirements in authorizing states would still be permitted to invest directly in equities and real estate up to 10% of their assets or twice their net worth.

Likewise, the FDIC is faced with the same problem of limiting exposure to its insurance fund, created by higher-risk activities authorized by various states for state-chartered institutions. In a second attempt to resolve this problem, FDIC has proposed to follow the FHLBB's example in setting a threshold amount for direct investment in real estate equities. The FDIC proposal would allow insured state banks in authorizing states to invest directly in real estate up to 50% of primary capital. Any excess investment, however, must be conducted through a separate subsidiary structured to insulate the bank and its insured deposits from any liability.

Although we applaud these actions by the regulators, we believe that it is Congress' role and responsibility to establish a consistent framework for changes in the activities of financial institutions. Without such Congressional direction, these regulators are faced with reacting, often haphazardly, to developments that determine <u>their</u> policies and not vice versa.

We concur with the legislation passed last year by the Senate that did not grant additional authority to federally-chartered institutions for real estate equity investments. Without Congressional action this year, situations such as the ones occurring in various states will continue. In addition, they will become increasingly more difficult for the regulators to control.

Thrift Asset Test

Mr. Chairman, although some broadened asset powers for thrifts were necessary for thrift institutions for times of financial stress in the 1980's, we can foresee serious consequences in the volume of home mortgage lending if thrifts drift completely away from their traditional role as the major suppliers of mortgage credit and venture into more nontraditional roles. The change in demographics alone will create greater demands for the availability of money for housing in the current decade. The secondary market for housing has expanded significantly over the last several years. At the current time there is no other viable solution for replacing the role of the thrifts as investors in housing. Many institutions can originate mortgages but it is essential that thrifts continue their important role as investors in housing. As such, these institutions receive special treatment for performing this function. We do not want to encourage loophole advantages for a few thrifts and their holding companies by neglecting

to recognize that obvious exceptions are available. For this reason, we encourage the committee to look carefully at the "nonthrift thrift" loophole and take corrective action.

NAHB supports a strong thrift assets test which will maintain the thrift committment to residential home lending. Currently the Savings and Loan Holding Company Act defines two types of holding companies, the unitary holding company and the multiple holding company. Restrictions are placed on multiple holding companies, but unitaries may be exempt from these restrictions as long as their subsidiary is a "qualified building and loan" according to IRS rules. We therefore feel the subsidiary should be subjected to a much stricter asset test.

The unitary savings and loan holding company exemption should remain a very limited exception to the separation of banking and commerce. For the most part, thrifts have continued to devote relatively large portions of their resources to residential housing. The qualifying thrift assets test would ensure that subsidiaries of unitary holding companies continue to focus their activities on residential home lending. We feel this would help foreclose potentially abusive activity for those few institutions which are searching for opportunities to use their subsidiary for other high risk purposes which could jeopardize consumer safeguards, consumer deposits, the FSLIC and the economy.

S. 2851 provided for a qualified thrift lender test, which we would like to see offered again in this year's legislation. Overall, we are pleased with the test which provided a limited amount of originations and prohibited FHLB advances for thrift institutions not in compliance with the qualified thrift lender. Federal Reserve Board Chairman Paul Volcker recommended an increase in the thrift asset test for qualifying investments to 65% of assets instead of 60% in his May 8 statement to this Committee. We basically agree with Chairman Volcker and supported his 65% recommendation in the House bill. We also agree with Mr. Volcker on the prohibited marketing of products of a nonthrift parent and vice versa. Should the dialogue reopen on the thrift test, we would like to take part in any additional discussions on this issue. We feel a strong assets test will maintain the thrift commitment to home lending. Moreover, if the unitary thrift is to remain a limited exception, certain safeguards, such as the ones mentioned above, are important for keeping the subsidiaries committed to residential lending.

CONCLUSION

In closing, I would like to emphasize NAHB's support of last year's legislation. We feel the legislative changes addressed in S.2851 are important considerations which need to be decided by the Congress and not the Courts.

We would like to see a strong thrift commitment to residential mortgage lending. Qualifying assets should be required at a minimum level to be in housing related loans. As I mentioned earlier, we will be happy to work with the Committee on any changes in this area.

I appreciate the opportunity to present the views of the National Association of Home Builders. I will be happy to answer questions from the Committee at this time.

National Association of Home Builders

15th and M Streets, N.W., Washington, D.C. 20005

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Peter D. Herder
1984 President

June 26, 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the more than 125,000 members of the National Association of Home Builders (NAHB), I am writing concerning the Finance Services Competitive Equity Act.

As you are aware, we have repeatedly expressed the serious concerns of our membership in opposition to any provision (whether passive, active or otherwise) of real estate equity powers for banks.

With that said, we support the more modest approach contained in the Committee Print to deal with the non-bank bank loophole, establish a "thriftness" test to maintain the essential relationship between thrift institutions and mortgage finance, and allow finance institutions to underwrite municipal bonds and mortgage-backed securities in order to expand the market and promote competition. We feel that this package represents a responsible way to deal with the immediate problems in the financial services industry.

We believe that the long-term issues of concentration of economic power in the finance industry; how to maintain the flow of credit to small business, farmers, communities and housing; and how to develop and maintain fair competition in the financial community are crucial to an overall long-term analysis of the future of the financial services industry. For our part, as part of a long-range planning process, we have begun to analyze the future sources of mortgage capital and how the mortgage delivery system will work during the 1980's and 1990's. We believe that these broader issues may well lend themselves to more comprehensive analysis by Congress and the Administration.

On balance, we urge you to support the Financial Services Competitive Equity Act as a measured step in the right direction.

Sincerely,

Peter D. Herder
President

National Association of Home Builders

15th and M Streets, N.W., Washington, D.C. 20005

Telex 89-2600 (202) 822-0400 (800) 368-5242

Peter D. Herder
1984 President

June 27 1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington D.C. 20510

Dear Mr. Chairman:

As a follow-up to our earlier conversation, we would like to expand on our views in support of the provision in the Committee Print which would allow thrift institutions and banks to issue, underwrite and market mortgage-backed securities. Such a provision would expand the market and promote competition in this essential area of mortgage finance.

This provision is especially important given the changes which are underway in the nation's housing finance system. A growing proportion of mortgages are being placed in securities and sold in the secondary market. The ability of thrift institutions and commercial banks to participate in all aspects of the mortgage-backed securities market will facilitate the development of this market and aid the housing finance system during a time of transition. This power will be especially helpful in local or regional markets if smaller institutions are able to package mortgages, issue, underwrite and market them in the form of securities. Such securities can be sold to specialized investors such as state or local pension funds or insurance companies and will therefore facilitate the flow of money to housing in these more local markets.

It appears to us that no credible argument has been made against granting financial institutions the limited power to issue such securities. Clearly the power to underwrite and market securities is in the consumer interest of providing an expanding supply of affordable mortgage credit.

We sincerely hope that this explanation of our views will prove helpful in the Committee's deliberations today.

Sincerely,

Peter D. Herder

Peter D. Herder
President

National Association of Home Builders

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Peter D. Herder
1984 President

September 6, 1984

Dear Senator:

I am writing on behalf of the more than 125,000 members of the National Association of Home Builders (NAHB) concerning S. 2851, the Financial Services Competitive Equity Act. I would like to express our support of this legislation which is important to the structure and operation of the banking industry, as well as the continued health of the housing industry. S. 2851 represents an appropriate legislative response to the issues raised by the rapidly changing financial services market place. We hope the Senate will act quickly and favorably on this legislation.

S. 2851 offers a solution to the nonbank bank loophole while reinforcing the historical separation between commerce and banking as well as preserving Federal and State control over activities of depository institutions and their geographic expansion. The bill also represents a measured step toward efficient financial services for consumers and businesses. Allowing depository institution affiliates to underwrite and deal in mortgage backed securities will expand the availability, as well as the affordability, of funds for housing finance. This provision should result in a healthy competitive environment between existing MBS underwriters and financial institutions' affiliates, thus lowering the cost of mortgage capital for home buyers. NAHB strongly encourages you to support this important provision which will help promote affordable housing.

NAHB recognizes the importance of a strong thrift assets test to ensure a responsible balance between housing finance needs and investment flexibility in thrift portfolio requirements. We are concerned that the House version of permissible assets is overly broad and will not strengthen the thrifts' commitment to housing. We also believe it is important for thrifts to meet the assets test every year rather than two out of three years as provided in the Senate bill. We urge the Senate to hold firm in conference with the House for the stronger Senate "thrift" provisions. We would be pleased to work with the Conference in developing a qualified thrift test which would maintain a strong thrift commitment to housing finance.

We urge you to support S. 2851 so that a bill establishing financial services equity can be enacted into law this Congress.

Sincerely,

Peter D. Herder

Peter D. Herder
President

President's Tax Reform Proposals Affecting Housing

I. Provisions Affecting Single-Family Housing

- o Repeal of itemized deductions for State and local taxes.
- o Curtailment of installment sale treatment for homeowner bonds.
- o Elimination of mortgage revenue bond financing.
- o Limitation on interest deductions for second homes.

II. Provisions Affecting Multifamily Housing

- o Replacement of Accelerated Capital Cost Recovery System with Capital Cost Recovery System.
- o Repeal of capical gain treatment on sale of depreciable property.
- o Repeal of 60-month amortization for low-income housing rehabilitation expenditures.
- o Repeal of 10-year amortization of construction period interest and taxes.
- o Repeal of tax-exempt industrial development bond financing for multifamily housing.
- o Repeal of rehabilitation tax credits.
- o Treatment of limited partner's interest as investment interest.
- o Extension of at-risk limitation to real estate activities.

III. Other

- o Rate reduction.
- o Increased zero bracket amount.
- o Alternative minimum taxes.
- o Inventory indexation.
- o Windfall tax on past depreciation.
- o Repeal of bad debt reserve deduction.

Short Summary of President's Tax Reform Proposals Affecting Housing

I. Provisions Affecting Single-Family Housing

A. Deduction for State and local taxes

Present law

Under present law, state and local taxes (i.e., real property, personal property, income, and general sales taxes) are deductible by itemizers, whether or not incurred in carrying on a trade or business or income-producing activity.

President's Proposal

Itemized deductions for State and local income taxes and for other State and local taxes that are not incurred in carrying on a trade or business or income producing activity would be repealed.

State and local taxes (other than income taxes) that are incurred in carrying on an income-producing activity would be aggregated with employee business expenses and other miscellaneous deductions, which would be deductible to the extent they exceed one percent of adjusted gross income.

Effective date-The proposal would be effective for tax years beginning on or after January 1, 1986.

B. Curtailment of installment sale treatment for homeowner bonds

Present law

When a taxpaper sells property under the installment method, income is reported as payments are received, rather than in the year of sale. Generally, if a taxpaper pledges an installment obligation as collateral for a loan, he can continue to defer gain under the installment method. This favorable tax treatment has led to the development of homeowner bond financing, which primarily has benefitted moderate-income first-time homebuyers.

President's Proposal

The proposal would restrict homeowner bond financing by requiring a homebuilder to recognize gain when he pledges homeowner bonds as collateral for a loan.

Effective date-The proposal would apply to installment obligations pledged as security on or after January 1, 1986.

In addition, indebtedness that is outstanding on January 1, 1991, which is secured by an installment obligation that was pledged as collateral prior to January 1, 1986, would be treated as if the installment obligation was pledged on January 1, 1991.

C. Elimination of mortgage revenue bond financing

Present law

State and local governments may issue tax-exempt mortgage revenue bonds to finance mortgages on owner-occupied residences. These bonds, which are targeted to economically distressed areas, are limited to first-time buyers of modestly-priced homes.

Mortgage revenue bonds currently are scheduled to "sunset" as of January 1, 1988.

President's Proposal

In general, interest on obligations issued by a State or local government would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government.

Effective date-Obligations issued on or after January 1, 1986.

D. Limitation on interest deductions for second homes

Present law

Currently, interest on home mortgages and consumer interest is deductible without limit.

President's Proposal

All interest, other than interest with respect to mortgages on principal residences and business interest, would be subject to a deduction limitation. Such interest (e.g., on second homes, auto loans, college loans, etc.) could be deducted only to the extent of net investment income (e.g., rents, royalties, dividends, and interest) plus $5,000.

Effective date-For taxable years beginning on or after January 1, 1986, the interest limitation would be $10,000 plus net investment income. For taxable years beginning on or after January 1, 1988, the limitation would be $5,000 plus net investment income.

The amount of interest subject to this limitation would be phased in at the rate of 10 percent per year, beginning in 1986.

II. Provisions Affecting Multifamily Housing

A. New Capital cost recovery system

Present law

Under present law, the cost of most real property is recovered over an 18-year period. Low-income housing, however, has a 15-year recovery period.

The depreciation schedule for 18-year real property is based on the 175 percent declining-balance method switching to the straight-line method. The depreciation schedule for low-income housing is based on the 200 percent declining balance method switching to the straight-line method.

President's Proposal

The accelerated cost recovery system would be replaced with the capital cost recovery system, which would provide a 28 year cost recovery period for all buildings. Depreciation allowances would be on a 112 percent declining-balance basis, producing an initial depreciation rate of 4 percent, switching to straight line after 4 years. The cost of depreciable property would be adjusted annually for inflation.

Effective date-Property placed in service on or after Juanuary 1, 1986.

B. Repeal of capital gain treatment on sale of depreciable property

Present law

Currently, gain on the sale of depreciable property used in a trade or business (e.g., an apartment building) is taxed at the preferential capital gains rate.

President's Proposal

Gain on the sale of depreciable property used in a trade or business would be taxed as ordinary income.

Effective date-Property placed in service on or after January 1, 1986.

C. Repeal of 60-month amortization of low-income housing rehabilitation expenditures

Present law

Certain expenses of rehabilitating low-income housing may be deducted over a 60-month period instead of being added to cost and recovered through depreciation.

President's Proposal

The election to amortize expenditures to rehabilitate low-income housing would be repealed.

Effective date-Expenditures paid or incurred on or after January 1, 1986.

D. Repeal of 10-year amortization of construction period interest and taxes

Present law

Construction period interest and taxes may be deducted over a 10-year period instead of being added to cost and recovered through depreciation.

President's Proposal

Construction period interest would have to be capitalized and recovered through depreciation deductions.

Effective date-Generally, interest expenses paid or incurred on or after January 1, 1986. However, the new rules would not apply to long-term contracts entered into before 1986.

E. Repeal of tax-exempt industrial development bonds for multifamily housing

Present law

Under present law, tax-exempt industrial development bonds may be used to finance projects for multifamily residential rental property.

President's Proposal

In general, interest on obligations issued by a State or local government would be taxable if more than one percent of the proceeds were used directly or indirectly by any person other than a State or local government.

Effective date-Obligations issued on or after January 1, 1986.

F. Repeal of rehabilitation tax credit

Present law

Currently, taxpayers are entitled to a tax credit for expenditures incurred to rehabilitate certain old or historic buildings. The credit rate is (1) 15 percent for buildings at least 30 years old; (2) 20 percent for buildings at least 40 years old; and (3)25 percent for certified historic structures.

The 25-percent credit is available for residential rental property (provided that all requisite conditions are met).

President's Proposal

The rehabilitation credit would be repealed.

Effective date-Expenditures incurred on or after January 1, 1986.

G. Treatment of limited partner's interest as investment interest

Present law

Currently, limited partners in real estate limited partnerships generally may deduct interest without limitation.

President's Proposal

The proposal would treat a limited partner's share of the partnership's interest expenses as investment interest. Thus, such interest, along with all other non-business interest, would be deductible only to the extent of $5,000 plus net investment income.

Effective date-For taxable years beginning on or after January 1, 1986, the interest limitation would be $10,000 plus net investment income. For taxable years beginning on or after January 1, 1988, the limitation would be $5,000 plus net investment income.

The amount of interest subject to this limitation would be phased in at the rate of 10 percent per year, beginning in 1986.

H. Extension of at-risk limitation to real estate activities

Present law

In general, an individual's losses with respect to any activity are limited to cash contributions and amounts for which he or she is personally liable (e.g., recourse borrowings). The at-risk rules, however, do not apply to real estate activities.

President's Proposal

The at-risk rules would be extended to real estate activities .

Effective date-Property acquired on or after January 1, 1986.

III. Other

A. Rate reduction

Present law

Currently, there are 14 individual income tax brackets, and a top individual tax rate of 50 percent.

The top corporate tax rate is 46 percent on taxable income in excess of $100,000.

President's proposal

The 14 individual tax brackets would be replaced by 3 rates: 15 percent, 25 percent, and 35 percent. For joint returns, the 35 percent rate would start at $70,000 of taxable income.

The top corporate tax rate would be 33 percent on income in excess of $75,000. For income under $75,000, there would be 3 rate brackets of 15 percent, 18 percent, and 25 percent.

Effective date-July 1, 1986.

B. Increased zero bracket amount and personal exemptions

Present law

Under present law, the zero bracket amount is $3,400 for a married couple filing a joint return. Each personal exemption is worth $1,000.

President's proposal

The zero bracket amount would be increased to $4,000 for joint returns ($2,900 for single taxpayers). The personal exemption would be increased to $2,000.

Effective date-January 1, 1986.

C. Alternative minimum taxes

Present law

Individuals

Individuals are subjet to an alternative minimum tax if that tax exceeds the individual's regular tax. The minimum tax rate is 20 percent. There is a $40,000 exemption for married couples and a $30,000 exemption for single individuals.

Corporations

Corporations are required to pay a minimum tax on certain tax preference items. This tax is in addition to the corporation's regular tax. The amount of the minimum tax is 15 percent of the corporation's tax preferences in excess of the greater of $10,000 or its regular income tax.

President's proposal

Individuals

The individual alternative minimum tax would be continued in a strengthened form.

The exemption would be reduced from $40,000 to $25,000 for married couples, and from $30,000 to $20,000 for single persons.

Unrealized gain from charitable contributions of appreciated property would become a tax preference item.

The preference for depreciation ("excess depreciation") would be computed by determining the difference between the proposed CCRS depreciation and the RCRS depreciation allowance proposed in Treasury I.

Corporations

The corporate minimum tax would be changed to an alternative minimum tax, similar in function to the individual alternative minimum tax.

The major preference items would be depreciation of real property (buildings) in excess of "economic depreciation"; the capital gains exclusion; and 25 percent of interest deductions up to the value of excess depreciation on personal property (vehicles and equipment).

Corporations would be entitled to a $25,000 preference exemption.

Effective date-January 1, 1986

D. Inventory indexation

Present law

Present law generally requires the use of inventory accounting methods where necessary to determine clearly a taxpayer's income.

President's proposal

A new, optional FIFO method of accounting, to be known as "indexed FIFO, would be developed. Under indexed FIFO, a published government price index would be used to adjust the inventory value for inflation.

In addition to inventory, the indexing method would be allowed for property held for sale in the ordinary course of business which may not constitute inventory (e.g., certain real estate held by a dealer in such property).

Effective date-Tax years beginning on or after January 1, 1987.

E. Windfall tax on past depreciation

Present law

No provision.

President's proposal

The proposal provides for a rate reduction recapture. Under this provision, 40 percent of the taxpayer's "excess deprecation" taken between January 1, 1980 and July 1, 1986 would be included in income over a three-year period (i.e., 12% of the excess depreciation in 1986, 12 % in 1987, and 16% in 1988).

Excess depreciation is defined as the excess of the actual cumulative depreciation or amortization deductions over cumulative depreciation deductions that would have been allowed using the straight-line method and the earnings and profits lives prescribed in Internal Revenue Code section 312 (i.e., 35 years for buildings until 1984 when it was lengthened to 40 years).

Taxpayers with cumulative depreciation deductions taken between January 1, 1980 and December 31, 1985 of less than $400,000 would not be subject to the rate reduction recapture. Furthermore, the first $300,000 of excess depreciation would be exempt from rate reduction recapture. Excess depreciation would be reduced by any net operating loss carryover from a year before 1986.

The rate reduction recapture would not affect basis. Thus, a sale of property at a profit would still generate the same recapture income as under present law.

Effective date-Applies to property placed in service on or after January 1, 1980 and before January 1, 1986.

F. Repeal of bad debt reserve deductions

Present law

Commercial banks and thrift institutions are permitted to deduct additions to reserves for bad debts using methods unrelated to their actual loan loss experience.

President's proposal

The special rules for commercial banks and thrift institutions for computing additions to bad debt reserves would be repealed. Thus, bad debt losses generally could be deducted only as they occur.

Effective date-Taxable years beginning on or after January 1, 1986.

The CHAIRMAN. Thank you, Mr. Colton.
Mr. Spiller.

STATEMENT OF ROBERT J. SPILLER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, BOSTON FIVE CENTS SAVINGS BANK, BOSTON, MA, PRESIDENT, MORTGAGE BANKERS ASSOCIATION

Mr. SPILLER. Mr. Chairman and members of the committee, my name is Bob Spiller. I am chairman and chief executive officer of the Boston Five Cents Savings Bank and I serve as president of the Mortgage Bankers Association of America.

We appreciate the opportunity to appear before the committee today to discuss several issues that affect the mortgage banking industry and which we feel this committee should consider in any legislation dealing with real estate financing.

DISCUSSION OF ISSUES AFFECTING MBA

There are six points I will enumerate to you and try to be as brief as possible.

The first item would be the authority to issue, underwrite, and deal in mortgage-backed securities. MBA urges Congress to authorize financial institutions to underwrite private mortgage-backed securities as nonrecourse obligations. Doing so will reduce the cost of these transactions, which are simply now passed along to the consumer/borrower. Frankly, I see no reason, as an issuer of these instruments, needlessly to enrich the people on Wall Street. I think they have enough money now and the financial institutions can handle those kinds of instruments as well as anyone on Wall Street.

On the qualified thrift lender test, the MBA urges that if a QTL test is adopted—and we do not support one—that it include an originations feature which would recognize the reality that institutions can supply large amounts of residential mortgage credit, even when they do not retain the mortgages in portfolio. As the chairman of a major thrift, this year as an example, we will probably gain in deposits $150 to $200 million and we will produce in the housing markets over $400 million of residential loans, and there is no reason why—that that kind of production simply will handle a great amount of residential commitment to this country and it can be done in a very meaningful way and a very profitable way.

The next issue is regulation of secondary Government securities dealers. MBA urges that any legislation ultimately enacted by Congress to regulate secondary Government securities dealers should not unduly impede or burden the liquidity or efficiency of the Government securities market, as this would result in higher mortgage interest rates for home buyers. For example, to require the physical transfer of the collateralizing security to the lender in a repurchase agreement would have such an effect. In addition, MBA believes that if this marketplace is to be regulated, the Federal Reserve Board is best suited for that role due to its experience in the oversight of primary Government securities dealers.

The third item relates to the override of State usury laws for second mortgages. MBA urges Congress to provide a Federal usury override for mortgages secured by a second lien on residential real

estate in the same fashion Congress enacted the Federal usury preemption, which now protects first-lien mortgages from restrictive State usury laws. That law on first mortgage liens and first mortgages works very well and it should work equally well on second mortgages. This also would provide for home owners the opportunity to go in and do the refinancing.

With respect to adjustable rate mortgages, ARM's, MBA opposes any Federal legislation that would place interest rate caps on lifetime or annual ARM adjustments or otherwise restrict the innovative development of ARM's because the industry has already devoted a great deal of effort toward developing instruments that provide consumer protections. MBA also supports the development of uniform disclosure requirements for ARM's and recommends that this responsibility be placed with the Federal Reserve Board. In the last year or so of experience that we have had in developing an ARM's booklet that we have offered to the public, we have worked with the Federal Reserve Board and with Fannie Mae and Freddie Mac, and we believe consumer knowledge in this area has come a long way and the abuses have been well regulated within the industry.

Finally, with respect to multiclass mortgage securities, MBA supports legislation that encourages the creation of multiclass mortgage securities. Such legislation would expand the universe of MBS investors who are willing to purchase mortgage products because such securities can be fashioned to accommodate their particular investment needs. MBA believes that all current participants in the secondary mortgage market, including Fannie Mae and Freddie Mac, should be allowed to issue multiclass securities.

We appreciate the opportunity to testify before this committee and I will be happy to answer any questions.

[The complete prepared statement follows:]

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Mortgage Bankers Association of America

STATEMENT OF

Robert J. Spiller
Chairman and Chief Executive Officer
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Boston, Massachusetts

on behalf
of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

Hearings on

Changes in the Financial Services Industry

June 18, 1985

Mr. Chairman and members of the Committee, my name is Robert J. Spiller. I am Chairman and Chief Executive Officer of The Boston Five Cents Savings Bank, which is located in Boston, Massachusetts. I am also President of the Mortgage Bankers Association of America.* MBA appreciates the opportunity to appear before the Committee today to discuss recent changes taking place in the financial services industry. Accompanying me today are Burton C. Wood, MBA's Legislative Counsel, and Brian D. Cooney, MBA's Associate Legislative Counsel.

Our testimony today will cover several issues that affect the mortgage banking industry and which we feel this Committee should consider in any legislation dealing with real estate financing. These issues include:

- Authority to issue, underwrite, and deal in mortgage-backed securities. MBA urges Congress to authorize financial institutions to underwrite private mortgage-backed securities (MBS) as non-recourse obligations.

- Qualified thrift lender (QTL) test. MBA urges that a QTL test include an originations feature which would recognize the reality that institutions can

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of mortgage and real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a variety of industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, financing, selling, and servicing real estate investment portfolios. Members include:

- o Mortgage Banking Companies
- o Mortgage Insurance Companies
- o Life Insurance Companies
- o Commercial Banks
- o Mutual Savings Banks
- o Savings and Loan Association
- o Mortgage Brokers
- o Title Companies
- o State Housing Agencies
- o Investment Bankers
- o Real Estate Investment Trusts

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supply large amounts of residential mortgage credit, even when they do not retain the mortgages in portfolio.

- Regulation of secondary government securities dealers. MBA urges that any legislation ultimately enacted by Congress to regulate secondary government securities dealers should not unduly impede or burden the liquidity or efficiency of the government securities market, as this would result in higher mortgage interest rates for homebuyers.

- Preemption of state usury laws for second mortgages. MBA urges Congress to provide a Federal usury premption for mortgages secured by a second lien on residential real estate in the same fashion Congress enacted the Federal usury preemption, which now protects first-lien mortgages from restrictive state usury laws.

- Adjustable rate mortgages (ARMs). MBA opposes any Federal legislation that would place interest rate "caps" on lifetime or annual ARM adjustments or otherwise restrict the innovative development of ARMs. MBA also supports the development of uniform disclosure requirements for ARMs.

- Multi-class mortgage securities. MBA supports legislation that encourages the creation of multi-class mortgage securities. Such legislation would expand the universe of MBS investors who are willing to purchase mortgage products because such securities can be fashioned to accommodate their particular investment needs.

AUTHORITY TO ISSUE, UNDERWRITE, AND DEAL IN MORTGAGE-BACKED SECURITIES

Authority to Underwrite and Deal in MBSs. Section 16 of the Glass-Steagall Act (12 U.S.C. Section 24 (7)) generally prohibits depository institutions from underwriting or dealing in securities that are not U.S. obligations. Nevertheless, these institutions are allowed to underwrite and deal in Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and Federal Home Loan Mortgage Corporation (FHLMC) securities, because these are considered to be U.S. obligations. Under this authority, these institutions have a well-established record of satisfactory performance in these securities.

MBA, therefore, urges the Committee to extend this authority to private MBS issuers. Doing so will reduce the cost of these transactions, which must be passed along to the consumer/borrower, by eliminating the significant transaction fees that would otherwise have to be paid for outside underwriting and dealing services. Lenders have a responsible track record in the government-related MBS area that should be considered. If the private-issue MBS market is being groomed to compete on an equal footing with government-related MBSs, then all factors should be made equivalent to foster that growth and competition.

Clarification of the Ability of Financial Institutions and Mortgage Bankers to Issue Pass-Through Securities. Although financial institutions currently have the authority to issue MBSs, there is a significant competitive disadvantage to their ability to do this, which has stymied the development of this market. Privately issued pass-through securities are treated as recourse obligations, so the issuer must then stand behind the collateral as a general obligor. This treatment requires the issuer to over-collateralize each security by

pledging additional assets. MBA urges the Committee to clarify the authority of financial institutions to issue private MBSs as non-recourse obligations.

Currently, most mortgage bankers can issue private MBSs without encountering this recourse problem, because they do not fall within the financial institution regulatory authority. Many mortgage bankers, however, are affiliated with financial institutions and thus are subject to the same regulatory authority as their parent banks or thrifts.

Moreover, MBA would like to clarify that most mortgage bankers are subject to Federal review and audit as HUD-approved mortgagees and FNMA/FHLMC seller-servicers. They must conduct their business under HUD's and/or FNMA/FHLMC guidelines and are subject to having their approved status terminated, along with their ability to participate in the various programs, should they fail to comply with applicable rules and regulations.

Additionally, the review performed by the rating organization of an MBS issue adds another layer of protection and assurance that all issuers, including mortgage bankers, will perform as promised. MBA believes that mortgage bankers, who have been instrumental in the growth of the secondary mortgage market, are experts in their field and should be allowed to expand their activities as marketplace innovations evolve.

QUALIFIED THRIFT LENDER TEST

MBA believes that depository institutions should be able to compete fully with their nonbank and nonthrift competitors in the provision of financial services. MBA, therefore, believes that the regulation of the product and geographic expansion capabilities of these institutions as well as the overall Federal regulatory scheme should not be so burdensome as to impede their ability to compete, while preserving their safety and soundness.

If the purpose of a qualified thrift lender (QTL) test is to ensure an institutional source of residential mortgage credit, then the means of ensuring that source should reflect the current market reality that mortgage lenders do not also have to be investors in mortgages in order to supply mortgage credit to borrowers. We strongly suggest that any QTL test include an originations feature, which would recognize the reality that institutions selling loans in the secondary market can supply large amounts of residential mortgage credit. If a QTL test is adopted by the Committee, we urge that mortgages originated for sale be eligible for inclusion in the test.

Because the QTL test would be an ongoing test, an institution would be required to roll over funds received from investors as payment for a pool of loans. A thrift must thus use its own funds to make loans. Once the thrift receives payment from the sale, it will, in most instances, be time to requalify for the QTL test and thus originate more mortgages with the rolled over funds.

In opposition to the allowance of a credit for mortgage banking originations, some have argued that there is a potential for abuse in that "double-counting" of some originations may occur. MBA believes that such potential for abuse is negligible, at best, because institutions that originate mortgages to be sold subsequently into the secondary market in the form of MBSs would not be likely purchasers of MBSs collateralized by a pool of the very mortgages sold. There may be isolated instances where a thrift counts a mortgage which is sold and then includes the cash received from the sale of the loan in qualifying toward the assets test. This presumes that both these events take place during a short period of time. Usually, there is a significant time lag between the origination of a loan and the inclusion of that loan in a pool commitment and final payment by the investor. MBA would support a provision similar to that contained in S 2581, which counted 50

percent of mortgage originations sold in the secondary market towards qualifying for the QTL test, up to a limit of 10 percent of the institution's assets.

REGULATION OF SECONDARY GOVERNMENT SECURITIES DEALERS

In the wake of the recent collapses of ESM Government Securities, Inc., Bevill Bresler and Shulman Asset Management Corporation, and Pace Securities, Inc., several bills have been introduced in each House of Congress relating to proposed regulation of secondary government securities dealers. One such bill, S 936, the "Public Securities Act of 1985," was recently introduced and referred to this Committee. A companion bill, H.R. 2032, has likewise been introduced in the House.

MBA is concerned with proposed regulation in this area because many of our members are issuers of GNMA, FNMA, and FHLMC MBSs. MBA believes that the abuses that have occured in this area are aberrational in nature and cannot be regulated against.

MBA strongly believes, however, that if regulation is imposed on the market, it should be carefully drawn so as not to impede the liquidity or the efficiency of the government securities market, as this would result in higher mortgage interest rates for homebuyers. Our main concerns in this area include which Federal government agency will be charged with the oversight function of the government securities market, and any proposed requirement to mandate physical delivery of securities collateralizing repurchase agreements.

Regarding the first item, MBA believes that the Federal Reserve Board (Fed), as opposed to the Securities and Exchange Commission, would be the logical choice as regulator of

this marketplace due to its experience in the regulation of primary securities dealers. The Fed's expertise will assure the continued efficiency of the marketplace, which in turn will attract investors due to the liquidity of government securities, and will result in lower interest rates for homebuyers. In addition, MBA believes that the Fed is the Federal agency best suited to regulate a marketplace which so strongly impacts upon both domestic and international currency markets.

With respect to the collateralization of repurchase agreements, currently there is a very large market for repurchase agreements collateralized by GNMA guaranteed securities, which include GNMA overnight repurchase agreements. As with other aspects of the government securities market, the ability of these agreements to be easily structured and packaged enhances the liquidity of the market and, therefore, makes the market attractive to investors. Generally, there is no physical transfer of the collateralizing GNMA security to the purchaser in a repurchase agreement, particularly with overnight repurchase agreements. The securities are, however, designated and segregated for the particular investor. In the vast majority of instances, this system operates efficiently. There has been some suggestion that requiring physical delivery of the collateralizing securities would reduce fraud and would enhance investor confidence in the government securities marketplace. To require the collateralizing GNMA security to be physically transferred to the lender would have a devastating effect on the market for GNMA securities. Since there is presently no electronic book entry system for GNMA securities, the overnight repurchase market could virtually shut down, should such a physical transfer requirement be imposed. This would have a significant effect on the Federal Housing Administration (FHA) insured and Veterans Administration (VA) guaranteed mortgage programs because the bulk of these mortgages are included in GNMA securities.

PREEMPTION OF STATE USURY LAWS FOR SECOND MORTGAGES

MBA urges Congress to provide a Federal usury preemption of state usury laws for mortgages secured by a second lien on residential real estate, in the same fashion as Congress enacted the Federal usury preemption, that now protects first-lien mortgages from restrictive state usury laws.

The demand for second-lien mortgage loans has increased dramatically in recent years. MBA's 1984 survey of mortgage banking companies indicates that mortgage bankers originated $863 million in second mortgage loans in 1983, the last year for which data is available, compared with $96 million in 1979. ("Loans Closed and Servicing Volume for the Mortgage Banking Industry," December 1984.)

The rapid increase in second-lien mortgage lending comes from increased use of such mortgages to facilitate first-lien transactions and from a desire of homeowners to borrow against their equity without paying off the existing first mortgage. Increasingly, buyers are forced to use second mortgages in purchasing a home, because the appreciation of house prices has exceeded the family's ability to save for a substantial downpayment, even though the buyers may have sufficient income to meet both first and second mortgages. In situations where existing first liens carry high prepayment penalties or carry interest rates much lower than current rates on new loans, second mortgages provide a means by which the homebuyer can "refinance" his mortgage investment without disturbing the first lien.

Second mortgages are also used to provide rehabilitation and repair of existing residential real properties. This is especially true in multi-family housing projects. It is becoming clear that as housing becomes more expensive, people are moving less, buying fewer "new"

homes, and instead, are repairing what they own. A second mortgage usury preemption would facilitate such a national rehabilitation effort. This is especially important for the elderly and for retired persons who have lived in their homes for decades and whose first mortgages are substantially paid down, but who need funds to rehabilitate their lifelong investment.

Second mortgages also are used extensively in large multi-family housing project developments where several lenders are involved. A second mortgage preemption also would facilitate new multi-family rental housing, which, as a percentage of new building, has been decreasing rapidly over the last decade.

Responding to and encouraging the increased market demand for funding based on home equity that does not disturb an existing, favorable-rate first-lien mortgage, FNMA entered the secondary market for second-lien mortgages in late 1981. When FNMA began to make commitments to purchase second-lien mortgages at yields of .25 percentage point higher than yields it required on first-lien mortgages, a new depth was brought to the secondary market for second mortgages. Not only is FNMA's activity helpful to mortgage originators who sell to FNMA, but the presence of FNMA in the market has provided reassurance for other lenders to enter the second-lien mortgage business.

In enacting Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980 (PL 96-221), which preempted state usury laws for first-lien mortgages, Congress recognized that anachronistic state legal limits on interest rates and discount points were impeding the operation of the nationwide mortgage market, and preventing the equal flow of mortgage credit to the Nation's citizens. Concerned lest the rights of the states be unnecessarily preempted, Congress allowed each state until April 1, 1983 to act to reimpose usury ceilings. Only 13 states chose to act to reassert jurisdiction over interest

rates on first-lien mortgages, and none of them has acted in a manner significantly detrimental to the market.

The impediments which interfered with the nationwide market for first mortgage financing continue to interfere with second mortgage borrowing. Eighteen states specifically limit second mortgage rates; the remaining states have a variety of laws restricting borrowing charges. As with first mortgages, such laws should be set aside, with, of course, the authority reserved to the states to reconsider imposing usury limits if any wishes to do so.

ADJUSTABLE RATE MORTGAGES

Adjustable rate mortgages (ARMs) are mortgages that provide for interest rate increases or decreases over the life of the loan, as adjusted pursuant to an agreed-upon index. In the 98th Congress, a bill, S 2581, the "Financial Services Competitive Equity Act," passed the Senate, but not the House. A floor amendment adopted by the Senate would have placed a "cap" or limit on the adjustments to interest rates, that lenders and borrowers could negotiate, of 5 percent on the amount by which the initial interest rate on any ARM under $500,000 could increase.

MBA is opposed to Federal legislation that would place interest rate caps on lifetime or annual ARM adjustments or otherwise restrict the innovative development of ARMs. Such restrictions would be short-sighted and largely unnecessary because the industry has devoted a great deal of effort to developing instruments that provide consumer protections, while at the same time ensuring continued investor interest in ARMs. MBA does support continued industry efforts to provide reasonable borrower protections of interest rate increases. Furthermore, MBA supports the standardization of ARM

disclosures. Standardization of documents and uniform requirements for hypotheticals and worst-case scenarios would remove a great deal of the confusion consumers may face when shopping for an ARM loan.

To date, we do not have any hard data on delinquency or foreclosure rates on ARMs. Because the widespread acceptance of ARMs has taken place only recently, the industry has not been able to gather the relevant data necessary to make a valid assessment. The adjustment periods on one- and three-year ARMs are occurring now. We do not have sufficient data to make a proper analysis. MBA's National Delinquency Survey data collection process is being reexamined now to seek a method of ascertaining information regarding ARMs default and foreclosure experience.

We do not yet know whether an upward adjustment in the ARM is a frequent reason for borrowers' delinquency or default. If a homebuyer suffers a financial crisis or is laid off and cannot make the mortgage payments, it does not matter whether the loan is a fixed rate or an ARM.

As mentioned, MBA strongly supports the standardization of ARMs disclosure requirements. In fact, in August 1984, MBA published a brochure entitled "What You Should Know About ARMs," a consumer information guide that explains the various features of ARM products. The varying disclosure requirements presently in force serve only to confuse the consumer and overburden the lender. Thus far, the Federal agencies have not been able to agree on uniform disclosure requirements and a uniform hypothetical example. A working group appointed by the Federal Financial Institution Examination Council (FFIEC) met throughout the fall of 1984 in an attempt to develop a uniform hypothetical example, acceptable to all the banking agencies, but ultimately no consensus was reached. The Federal Reserve Board has released a proposed amendment

to Regulation Z which provides disclosure requirements for ARMs. However, there is no assurance that the other Federal agencies that impose disclosure requirements on ARMs will repeal their regulations once the Federal Reserve Board's proposal is finalized. MBA, therefore, urges the Congress to make the Federal Reserve Board the sole regulator in the area of ARMs disclosures.

MULTI-CLASS MORTGAGE SECURITIES

Recently, there have been legislative proposals discussed that would provide for amending the tax laws in order to permit the issuance of multi-class mortgage securities with differing maturities backed by a single pool of mortgages. The proposals would remove tax liability at the pool level for MBSs that are set up under specified guidelines. With these tax law amendments, MBSs could be issued that resembled collateralized mortgage obligations (CMOs) and offered investors a choice of maturities lessening the unpredictability of prepayments, without the expense of creating the legal and accounting structure necessary for a CMO. Thus, issuers could have the benefits of CMOs, including sale of assets treatment for accounting purposes, without the expense of CMOs. The extraordinary success of CMO offerings indicates that investors who require guaranteed maturities are highly attracted to instruments that can provide this assurance.

MBA believes that all current participants in the secondary mortgage market, including FNMA and FHLMC, should be allowed to issue multi-class securities, or at the very least legislation should allow FNMA, FHLMC, and GNMA securities to be used as collateral for privately issued multi-class securities.

Historically, GNMA, FNMA, and FHLMC have led the development of mortgage-backed securities. While there have been some conventional MBS (CMBS) issues floated in the

last fews years that are not backed or collateralized by GNMA, FNMA or FHLMC MBSs, these comprise a small percentage of the total market. Most privately issued CMOs or "builder bonds" are backed by securities guaranteed by one of the three Federal agencies.

With potential home mortgage credit demand at historically high levels and the increased reliance on the secondary market, MBA believes that the emphasis should be on removing all artificial impediments to the free flow of mortgage credit and enlarging both general sources of mortgage credit--private and Government-related--rather than arbitrarily shrinking the role of Government and Government-related agencies on the untested assumption that private institutions could immediately pick up the slack.

Furthermore, it is clear that private and Government-backed markets can coexist and compete with one another, as evidenced by the strength of the conventional mortgage insurance industry and its phenomenal growth during the 1970s, despite the presence of FHA home mortgage insurance programs and the VA home loan guaranty program. Rather, these programs served to prove the actuarial viability of mortgage insurance and amortized, long-term mortgages. Furthermore, FNMA and FHLMC, the principal secondary markets for privately insured conventional loans, provided standardization, which is vitally necessary to the evolution and development of these types of mortgage instruments.

Another benefit of allowing FNMA and FHLMC to participate in the issuance of multi-class securities is that their activity can serve to establish a benchmark for pricing private issuances and ensure that there is competitive pricing for loans in this price range. The presence of FNMA and FHLMC will simply keep other issuers "honest" by providing another source of competition, contributing to the efficiency of the market.

MBA believes that the inclusion of FNMA and FHLMC would serve to propel the development of these markets, rather than inhibit private entries. The passage of these initiatives will introduce a new era in mortgage finance, similar to the early 1970s. The federally sponsored instrumentalities will serve as a catalyst to these developing markets, as their presence would provide the standardization and volume that is necessary for CMBSs to attract investor interest. Those two factors are necessary to ensure that the products offered will be liquid and marketable. Furthermore, the participation of FNMA and FHLMC in all geographic markets and during all economic cycles will add much needed stability to the marketplace and, thus, will serve as a presence that investors may use as a benchmark against which to judge privately backed issuances. This stability still will allow experimental and custom-tailored CMBSs to be marketed, but the market will be able to judge offerings against a standardized version.

MBA supports legislation authorizing the creation of multi-class securities as a means of expanding the universe of investors who are willing to purchase mortgage products that can be fashioned to accommodate their investment needs.

Thank you very much for this opportunity to testify. I would be happy to answer any questions you might have.

The CHAIRMAN. Thank you, Mr. Spiller.

Mr. Colton, I appreciate your strong support of S. 2851, particularly the mortgaged-backed securities area. I'm sure that you would agree that with the crisis that we have experienced over the last 3 or 4 years, particularly in the savings and loan industry, although they are recovering and there were rather large profits last year in some of them, it's a little bit deceiving--industrywide it looks good, but there are some very tough pockets there of some institutions that are still in great difficulty. And it appears that those who predicted, with the passage of Garn-St Germain, that thrifts would abandon housing mortgages and the housing industry, have not. As a matter of fact, it's my understanding that more than 54 percent of the mortgages last year were still from the so-called thrift industry. So that has not taken place.

INDUSTRY STILL ON THIN ICE

Nevertheless, even though the picture is much better for S&L's, I would suggest the industry is still on rather thin ice and can no longer afford to be engaged in long-term fixed-rate mortgages to get themselves back in the same problem that they have been in the last 3 or 4 years.

So it is my feeling that everything that we can do to enhance the secondary mortgage market to find ways that the thrift industry can stay in the mortgage lending business without entrapping themselves in that problem of borrowing short and lending long, we must do.

That's why I feel so very strongly--and I appreciate your testimony on mortgage-backed securities. A lot of people have attempted to equate S. 2851 with safety and soundness, that somehow we are emasculating Glass-Steagall, when in fact the mortgage-backed securities were the major new power granted. The only other one granted to banks was municipal revenue bonds and then we ratified a couple of provisions or discount brokerage and so on that were already being done by banks and simply saying, yes, let them go ahead.

So with your strong support I want to take the opportunity once again to say over and over that rather than being the cause of the failures within the financial services industry, of traditional depository institutions, that the limited expanded powers granted in Garn-St Germain and the again very limited additional powers in S. 2851, would strengthen these institutions rather than weaken them.

Would you agree with that?

Mr. COLTON. I certainly would, Senator. We obviously have supported in the past and would like to reiterate again that we intend to support with all that we can do the inclusion of these powers in this legislation.

As you noted, in the range of one-half to two-thirds of the mortgages which were originated in the marketplace now pass through the secondary market. Quite frankly, this is an opportunity for the thrift industry and an opportunity for all financial institutions to participate in the profits to be gained from this major new segment of housing finance.

At the same time, and what we reiterated in our testimony, is that providing thrift institutions this power will actually provide housing particularly in some local and regional areas and will really open up new markets. The underwriters on Wall Street are very interested in big transactions. They are not as interested in the smaller transactions. And I think you will actually see thrift institutions opening up additional sources of credit through pension funds and insurance companies which will help housing, especially in certain local, State, and regional markets.

So our support is strong and it will continue.

The CHAIRMAN. Well, it goes far beyond just the thrifts to a lot of carpenters, bricklayers, sheet metal workers, and so on who build houses.

Mr. COLTON. Exactly.

The CHAIRMAN. So it's one thing I've tried to point out for a long time. The issue is far broader than a couple of additional powers for depository institutions. It's what happens to the whole construction industry in this country.

EFFECTS OF TAX CODE CHANGES

And although this is diverting from our hearings in this committee and we have no jurisdiction, what is your opinion of doing away with the second mortgage or so-called vacation home deduction in the Tax Code?

Mr. COLTON. I'm glad you asked that, Senator. First, let me say that in a broad sense we are obviously looking very carefully at all dimensions of tax reform as they relate to housing. In fact we would encourage this committee perhaps to look closely at that yourselves in terms of what the impact will be on housing because there are a number of propose in the tax reform proposal as set forth by the administration which will impact housing.

You mentioned one of those, limiting the interest that would be allowable with respect to second homes. Second, I think that that will have two potential impacts. First, that will obviously discourage some buyers and some construction therefore that would be related to second homes. I think the most potentially damaging consequence as far as the economy as a whole relates to certain areas of the economy.

We have done some analyses and have discovered that in some areas of the country and some counties between 20 and 50 percent and even higher than 50 percent of the homes in that particular area are actually second homes. This limitation will obviously have an impact on those areas of the economy and will have an impact on production.

It's also our estimate that in the range of about 80,000 housing starts in 1984 were second homes. Again, though, I would say, without stressing this particular measure in and of itself, that I think that it's important to step back and look at the entire piece as a tax reform. It's obviously tough to be against tax reform and tax simplification per se. NAHB is trying to be broad in our focus, but we are trying to point out that there are serious impacts as they relate to housing, both single family and home ownership, and we

express some desire on the part of this committee to get into that issue so we could focus on it in greater depth.

The CHAIRMAN. Well, of course, we don't have direct jurisdiction over tax matters, but I would agree with you that, although we will not be involved in the markup, certainly we have responsibility for housing in this country and it does have, in my opinion, a very serious impact on housing. I frankly don't think the administration has really thought this one provision through.

It's very populist I understand to say, look, if somebody can afford a second home, particularly when you're looking at resort area condominiums and saying somebody from Texas can come up and buy a half-million dollar condo in Park City, UT, why should they be allowed to deduct that. Well, I don't think they have thought it through beyond that populist approach because in 1981, 1982, and 1983, in my home State—and this is true of a lot of other States—the only real home building that was going on was in the resort communities and you can still say, well, so what? Rich people can afford this. But I don't know what would have happened to the construction trade in my State. The unemployment level was extremely high, despite the fact that we were building some of those expensive condos in the ski areas, but the carpenters, plumbers, bricklayers, and so on did not care who was buying, if they were working. And I don't think the Treasury has carried through to find out how much taxes were paid on those wages as an offset to the deduction. I don't think they followed through to see how much lumber was sold and how much brick and all the suppliers and the subcontractors that went into that.

Now their answer to this is, what you said, you've got to look at the overall tax simplification in context, and I agree with that. The overall rates would come down and therefore these people would not have paid any more taxes so it's a wash. Well, it may be a wash in the overall revenues. It is not a wash as to where that money is going and the likelihood of them directing it to housing would probably not be there. People would just keep on paying more taxes, therefore I don't have to invest in a home to do it.

I think the impact on the construction trades and the home building industry would be a great deal more severe than a lot of people think and we ought to consider that rather than just looking at the populist appeal of once again saying, well, we'll hit those people that can afford to own a second home because it goes beyond the luxury home as well. A lot of people, who may be investing in a small duplex, are elderly and retired people with a little bit of income, and have that for a retirement situation. I really don't think the administration has looked very carefully into the impact it would have on home building in this country.

Mr. COLTON. Just to reiterate what you said, Mr. Chairman, three quick points. First of all, the impact has already been felt in a number of areas of the country because the provision has been on the table now for the last 6 or 7 months. There already has been an impact. We've seen a lot of layoffs of construction workers and people who are involved. So what you say is true. It's already been felt.

The second point that you made, we are trying right now to put together data to document the fact that a lot of the second homes

in the country are not high-income condominiums, but in fact they do serve the moderate-income population in the country and provide an investment opportunity for these people.

The third point is that the revenue impact of this measure is miniscule. Quite frankly, especially for those that are fairly well off, there are plenty of ways to get around this provision if you add the $5,000 cap. So the revenue impact of expanding deduction to second homes is miniscule and it just makes very little sense, in my mind, for the administration to maintain that provision in the bill.

The CHAIRMAN. Well, if anybody had any sense and they've got two homes, all they would have to do is go get a huge mortgage on one and pay off the other one. So that's why I'm surprised that it is being pushed by this administration because I don't think it has been well thought through. You get no more revenue, maybe a pat on the back for hitting so-called rich people who can afford those condos, but it has not been well thought through at all. Again, the reason I bring this up here is not that we have jurisdiction, but simply we do have a responsibility for housing and I think it will have a serious impact on housing. We've got enough problems with putting people in adequate housing now and having them be able to qualify for loans and be able to get into affordable housing without compounding the problem.

Senator Riegle.

NEED TO GET PRINCIPAL PLAYERS TOGETHER

Senator RIEGLE. Mr. Chairman, I think the issue that you have raised—and it's the one that I intended to raise today—has to do with the impact of potential tax changes on homeownership, housing affordability and the housing industry. Mr. Chairman, although the Finance Committee will write the legislation, as you point out, we are the committee with the responsibility for looking at the future of housing in this country. I will formally suggest in letter form that we hold a hearing to which we invite the principal players in the housing market in the United States—the realtors, the home builders, representatives from the construction trades, home financiers and others who ought to be included. Then we should really try to understand the ramifications these changes might have on housing costs, housing starts, and dislocations.

It's interesting, as you point out, that since these proposals have been on the table there's been an impact even before the law has been changed. I'm hearing that from people around the country as well.

The CHAIRMAN. Let me just say to the Senator from Michigan that I fully intend to express to the committee holding the hearing that where we have no jurisdiction whatsoever, we can certainly make recommendations to the Finance Committee and with our heavy responsibility in housing I certainly intended to do that.

Senator RIEGLE. Excellent. I'm glad to hear that. I will certainly work with the chairman on that hearing.

You did not mention, Mr. Colton, the proposal to eliminate the deduction of State and local taxes in your comments. You talked simply about the interest deductions on second homes.

As I consider the potential removal of the deduction of property taxes and income taxes from individuals it seems to me that will also have a very major impact on home ownership. Is that your sense?

Mr. COLTON. Absolutely. And obviously this is not the purpose of this hearing, but I should say we have identified about a dozen areas which have significant impact in the area of home ownership and in the area of rental housing.

For example, we have developed a computer model as far as the impacts on home ownership costs and the impacts on required rents of the President's proposal and the results of that computer model will be available within the next week or 1½ weeks. We wanted to do the full analysis before we released those.

Related to home ownership, it's our estimate—and this obviously varies significantly depending upon the type of household and depending upon the State one resides in—but home ownership costs rise under this proposal in the range of 10 to 20 percent. Now a certain amount of that is offset by virtue of what Senator Garn was referring to, that some households will pay less taxes and therefore will have more money available. But the large majority of that increase as far as home ownership cost has to do with the impact of removing the deduction for property taxes.

So there is a significant impact on home ownership costs.

I might also add that that hits hardest to the first-time buyer. The person who already owns a home is in a position quite frankly to benefit from the offset as far as the deduction in taxes; however, for somebody who is just getting into the marketplace that inability to deduct property tax will make a major difference on the margin for that person to be able to qualify for a home or to purchase a home.

So the major impacts on home ownership in the President's proposal relate to first-time buyers, not only the property tax laws, the mortgage revenue bonds, or removing the insolvent treatment as it would relate to builder bonds or home owner bonds, so that I think answers your question.

Senator RIEGLE. It's very difficult to analyze the tax package. It's about a 500-page document, as you know. It's like the New York City phone book with its fine print. I've been holding tax forums around my State of Michigan where citizens come in and we discuss the proposal together. But it's a very complex simplification when you get into it.

But one of the interesting ironies—and my chairman will appreciate this—that the proposal includes a large increase in the personal exemption but sets it off against a removal of the deduction for State and local taxes.

The CHAIRMAN. As the Senator knows, I'm in favor of that one.

Senator RIEGLE. Yes, I know, and you probably will be going back into production soon.

The CHAIRMAN. No, I've quit. [Laughter.]

Senator RIEGLE. You said that after the fourth child, so I'm not sure I believe that.

But in any event, you could have the anomaly of a family that's renting and trying to become first-time homeowners finding that the financial threshold has suddenly been lifted. So it's more diffi-

cult to be able to come up with the cash needed to buy a home and start to become a homeowner. So the tax law could provide an incentive to first start expanding your family by having more children to get more tax deductions. But then, you more quickly need a bigger house with more bedrooms. So you can see how the Tax Code can put someone in a bind as they find that, while they continue to get more and more personal exemptions for additional children, the size of the house they need gets larger and more expensive. So they might never quite make it.

IMPORTANCE OF ECONOMETRIC ASSESSMENT

All kinds of things like this are built in. It seems to me, as you say, that until we have a thorough econometric analysis of the net of all these changes, particularly the ones affecting housing, it's awfully hard to know precisely what the impact will be. It also looks to me that the impact will differ, not just among families of different sizes in different locations, but among families of exactly the same condition, same size, same income circumstances, that happen to be in one area versus another. You're going to see quite a different kind of after-tax impact if this proposal passes unchanged.

So it's very important for you to complete that econometric assessment. Then when this hearing takes place let us go over it so that we have a way of seeing what the bottom line is on housing.

I, for one, am very reluctant to see the country move away from a commitment to the notion that all working people and individuals and families should have the chance, and a very real chance, of moving into home ownership. To me, that's a central part of what we ought to be trying to accomplish in the way our economic system is structured. If it develops that we are steering away from that goal, and we have been doing so for other reasons in a period of high-interest rates, I feel that would be a powerful reason to do some fine tuning and reengineering of the tax changes. Because I am for tax reform and for simplification, I think the President is correct in raising these issues, but it's essential that it be done right. We don't want to enact massive changes and then find out that in pursuit of a good concept, we end up with results that were unintended and, in fact, wouldn't be healthy for the country or for the people of the country.

So in any event, I will wait to hear from you on that issue. I appreciate both of your comments on the financial deregulation issue.

That's all for me at this point, Mr. Chairman.

The CHAIRMAN. Let me just follow up on that one more time because I know it's easy for all of us to say we are for tax simplification and reform and at the same time we disagree with different parts. That will take place in this debate as it goes on over a period of months.

The reason I stress housing is I've been involved in it for a long time at both ends—as a mayor trying to find everything from emergency low-income housing to get the poor people off the streets where they have no place to go to find more adequate housing for lower income groups, and to find private sector housing for people of all income groups.

We made a national policy decision a long time ago on this kind of a deduction for a specific purpose because we made a conscious decision that home ownership was good for the country. In all the years I've spent in it, now 20 years, I can guarantee you that home ownership does provide a lot of social benefits that you cannot measure in terms of dollars. You look at people who have moved from rental units in some of the so-called urban slums that we have had in the past or some of the giant HUD projects in public housing. When those people owned their own homes, it was amazing the difference in attitude that occurred and how they were taken care of. I don't know how you put a dollar amount on those, but home ownership is an extremely valuable commodity in this country.

And you can carry it a step further, too, that the overall tax rate may be lower and the individuals may not be paying any more taxes than the net effect of these provisions. However, if you abandon that commitment to housing, then we are going to be here arguing before this committee for more subsidized housing, for more 235 programs, for more section 8. I will guarantee you, you will gain a lot more money than you ever would gain in abandoning that commitment by going back to the route of public housing which in so many cases has been so incredibly expensive. And it's right at the time when we've been cutting back in the last 3 or 4 years in various types of public housing programs. I think we've got to carry it that one step further.

Then, what is asked of us in light of the $200 billion budget deficit is to provide public housing or subsidies for the public as opposed to private sector housing. So again I don't want to carry it on any longer other than to say that I still feel we should maintain a strong commitment to housing in this country. I don't think there's any anchor or foundation that helps the social fabric of this country more than somebody owning their own little plot of ground with their own house on it, however humble. If we abandon that in the name of tax reform, we have made a very, very serious mistake.

Senator RIEGLE. Mr. Chairman, might I add one other thought here in light of your comment? Other estimates that I have seen suggest that the cost of producing rental housing is going to rise and so rents will rise. I've seen figures anywhere from 20 to 30 to 35 percent as the resulting rent increases as the effect of the tax changes. That's a huge step up in rental costs, in rents being charged to renters. And my concern is that if you assume that people are renting on their way to home ownership, they must try to accumulate a nest egg, try to get a downpayment together and try to work their way out of a rental situation and into home ownership. If rents go up sharply during the same time, it's going to be more difficult to acquire a house. Then they will tend to get more mired down into the renter situation and can't accumulate the nest egg as readily if their rents are higher. Therefore they may be stuck in rental housing indefinitely.

And I don't want to see that either. In other words, I really want to see us in a situation where families or individuals who are trying to start their work career and trying to move out of a rental situation into their own home, will be able to do it. I don't want to

stack the deck against that opportunity, and it seems to me that when you add the apparent increase in rents that's likely to occur here, it's a double-barreled negative effect. You're actually moving home ownership even further out of reach to that person because you're depleting his income for the cost of the rent that he pays.

In any event, these are awfully important issues I think for us to track down and I want to work with the chairman on them. I serve as the ranking Democrat on the Housing Subcommittee so, as he has properly said, we really have the oversight responsibility to try to fathom where these changes will take us. Hopefully we can develop that information and put it on the table for everybody to take a look at.

INCREASE OF 20–25 PERCENT FOR FINANCED RENTAL HOUSING

Mr. COLTON. Senator Riegle, I just might say in response to that that you're absolutely right. Our computer models—and we just completed them with respect to the President's proposal—show an increase—and we can get into this in more detail later—in the range of 20 to 25 percent for conventionally financed rental housing for required rents. This is if you were going to an economically feasible project. And 40 percent if you take into consideration tax-exempt financing and the removal of IDB's. So this is the President's proposal.

That obviously will not happen because that project will not be economically feasible. So production will stop and rents will gradually rise over time. But the phenomenon that both of you have talked about is absolutely true.

As you mentioned, Senator Garn, we supported the cutbacks in section 8 and the Subsidized Housing Programs. One of the reasons we have been willing to do that is because you do have the Tax Code as a way of producing affordable rental housing. If you remove that through the Tax Code, it's going to be very costly to the Federal Government ultimately and, therefore, we concur with the issues you're raising very strongly.

The CHAIRMAN. Mr. Spiller, you can either feel greatly relieved at this incursion of housing or disappointed that you didn't get asked a lot of questions today. Let me just ask you one.

Both the U.S. League and the National Council suggested a more flexible thrift test which requires their commitment to housing without impairing the ability to compete or causing them to become illiquid. Should the qualified thrift lender test expand the amount permitted in liquid assets?

Mr. SPILLER. I missed the last part.

The CHAIRMAN. Should the qualified thrift lender test expand the amount permitted in liquid assets?

Mr. SPILLER. Looking at it as the principal of a thrift—because I've spent 10 years digging ourselves out of a box and becoming profitable and becoming strong and having the right kind of equity that enables us to do the things we ought to do—what I don't want to see happening, at least from my own viewpoint, is restrictions that impede my ability to compete, particularly with the kind of fluctuating mortgage rates that we see today with the wide fluctuations. I don't want to have to put back on our books a large per-

centage of fixed-rate 30-year mortgages which will once again choke us as they did 10 ot 15 years ago or else I will have no hair left rather than just white hair.

The CHAIRMAN. You should never worry about the color. [Laughter.]

Mr. SPILLER. That's right. On the liquidity side, I haven't really focused long and hard on that. I have focused on the other issue of having a certain percent of the deposits or the assets locked up in that 50–60 percent range. My key feeling is that if we are in secondary markets and we are floating a greater amount of money, either deposits or our ability to borrow, through there and providing a substantial amount of mortgages, then I think we should count those to whatever degree is possible. We don't want to get caught in another sqeeze because the other result is simply to remove the thrift industry from being a competitive marketplace and then there would be no money available.

The CHAIRMAN. Gentlemen, thank you very much. We appreciate your testimony.

[Responses to written questions of Senator Garn follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN FROM KENNETH F. X. ALBERS

1. How do we preserve the dual banking system if states act too aggressively in permitting an unlimited amount of investment in the name of innovation - when we realize that "excesses" may well result in losses to the federal insurance system?

Somewhere between unlimited state authority and no state authority is a proper balance which preserves the innovation benefits of the dual system while protecting the legitimate interest of the federal deposit insuring agencies. This balancing act is not new. The balancing act will never be "perfectly" or "finally" resolved.

In our view, the proper role (and the historic one at that) of the federal agencies is to determine what activities present a safety and soundness threat. Investment activities such as real estate development are not unsafe or unsound per se but, like any other investment option, can be abused if used unwisely or impudently. The key is for the examination and supervision process to discover and promptly deal with individual problem cases as opposed to across-the-board regulations or preemptions of state powers.

2. I have been advised that thrifts affiliated with unitary S/Ls have traditionally been among the strongest and most profitable institutions. Is this true? Would imposing a qualified thrift lender test weaken these institutions? Would restricting tandem sales weaken them? If so, how?

There is no hard evidence to support or refute that statement. For the most part, thrifts which are affiliated with unitary holding companies have benefited from the diversification opportunity and are, generally speaking, less vulnerable to the cycles of the housing market. The tandem restriction and the qualified thrift lender test have one thing in common. Each would limit the business opportunities, narrow the operating flexibility of the thrift and thereby, potentially restrict the profitability of thrift institutions.

3. You mentioned a program which permits the FSLIC to take advantage of industry expertise in the management of troubled institutions and their problem assets. Will you describe this program in more detail? Is it being used today? If so, with what success?

Presently, the FHLBB has the power to seize control of thrift institutions it deems to have failed and replace the management of these institutions. It has done so in five cases, most recently the case of Sunrise Savings in Boynton Beach, Florida and Bell Savings in San Mateo, California. In each case, it has concluded a management agreement with a healthy thrift that will provide, for a fee, the management services the Bank Board deems necessary in winding down the operations of the thrift. The motivation in these management contracts can either be to turn around the operations of the institution to make it viable within its market, or to simply serve as caretaker until such time as the assets and liabilities of the thrift can be sold off and the institution phased out of business. Due to the recent use of this program, it is impossible to judge its success. In most cases, the problems of the troubled institution are such that it will take a great deal of time for the situation to be reversed or the finances of the thrift untangled to the point where sale is possible.

4. With regard to enforcement powers, the FDIC and the OCC have proposed disclosure of formal administrative cease and desist actions against officers of institutions which are slow to respond to informal agreement to modify an institution's activity. Wouldn't this step help insure management cooperation with its regulator?

On July 30 of 1984, the National Council filed a formal comment of such a proposal. I am enclosing a copy of that statement.

5. Do you believe that the frequency and amount of civil money penalties should be increased?

The National Council supports the current authority of the federal agencies to deal with cases of fraud, insider abuse and violations of federal laws. We believe that the $1,000 per day penalty that currently is permitted is adequate.

6. What is your view on prohibiting savings and loans from cross-marketing financial services to its customers if those services cannot be offered by a bank holding company? What are the advantages of cross-marketing - to an institution and to the consumer? Any evidence of abuse?

Cross-selling (or tandem) operations are part of the dynamic evolution of the financial marketplace. Much like the development of the department store and supermarket, it is driven by a perception of consumer desire for convenience and cost effectiveness. Of course both of the analogous retailing examples were not, in the early stages of their development, without great cries of anguish by victims of competition. Tandem sales is attacked by those who fear competition and who cannot or will not meet the competition. To our knowledge, there have been no abuses at all.

If thrifts are offering services that banks can't offer, our solution is simple - let the banks offer the services.

7. Mr. Colton testified that one half to two thirds of all mortgages originated currently end up in the secondary market. Many project this number to increase. If it does, and Congress passes a strict thrift asset test, how will thrifts be able to comply?

A great many thrifts have restructured their operations to include a significant mortgage banking component. The motivation here is twofold: origination and servicing (as opposed to investment) activities generate fees that enhance income without increasing the exposure of the institution to interest rate swings; in addition, a mortgage banking function allows the thrift to employ a variety of mortgage market strategies. It can choose which loans it wishes to hold and it can access capital markets on a regular basis. The imposition of a qualified thrift lender test that does not adequately credit the mortgage banking activities of thrifts will undervalue their contribution to the housing finance market and cause severe disruption of current operating practices.

8. Why should bank and thrift holding companies be given the authority to underwrite and distribute mortgage backed securities?

The quality of an MBS issue goes directly to the underwriting of the mortgage loans backing the issue. Who knows this field better than the traditional mortgage underwriting specialist? Furthermore, in order for thrifts to remain in the mortgage field and also remain profitable they must be able to adopt to the evolution of that market. To deny us this authority is to deny us access to one of the most lucrative parts of the mortgage market.

As a practical matter, many of our members have been active sellers of mortgages in the secondary market and as such, have had to develop the skills and contacts to establish an investor base. The originating and marketing of MBS will be a natural corollary to this already common practice.

9. In his testimony, Doug Timmerman of Anchor Savings and Loan believed that affiliating with a realtor was a natural progression for his company. Do you believe a federal savings and loan should be given the same authority? Why?

We agree that, like MBS dealing, real estate brokerage is a natural extension of the thrifts' traditional home finance role. Given the changes in the home finance market, in our view, the only way we can stay in housing and remain profitable is to be able to compete in every part of the housing equation. We would certainly agree that real estate brokerage is a natural by-product of the historic role the thrifts have played in housing. As we have stated elsewhere, the dynamics of the housing market is changing in such a way that many, if not most, thrifts will have to change the manner in which they participate in that market. For many associations the key is "staying in housing" is to be involved in all aspects of housing, not just the lending mentioned above.

10. What percentage of your association's member institutions would not qualify under the qualified thrift lender test contained in S. 2851? In H.R. 20? What changes, if any, would you recommend to the thrift test of last year's Senate bill? Why?

At present, about half our members would not qualify under the thrift test as specified in the Senate and House bills. Changes in these proposals would have to include substantial credit for mortgage banking activities and liquidity investment. Regardless of the components of a thrift test, we believe that the concept itself is inconsistent with the thrust toward financial deregulation. By March 1986, all banks and thrifts will have 100% of their deposits deregulated. For the federal government to then dictate that one segment of the market must allocate 65% of its assets to one type of of holding in any and all economic and market circumstances is unfair from a competitive point of view and unsound from an economic standpoint.

11. The comment has been heard from many quarters of the need to restructure FSLIC to be sure that it will continue to have the confidence of depositors it insures. Would you comment on the form this restructuring should take?

At present, the Council has two high-level task forces examining the problems of the thrift industry and the FSLIC. We are looking closely at both variable insurance premiums and variable capital requirements as methods of restoring the soundness of the insurance fund, as well as the tradeoffs between the two methods as they affect the thrift industry. We anticipate a full report from these task forces in the fall and will be glad to share our recommendations with the Committee as well as cooperate fully in the Committee's deliberations on this topic.

12. You and Mr. Brooks recommend that the net worth certificate program be extended, but make the recommendation without mentioning any definitive benefits of the program to date. The General Accounting Office is reviewing the net worth certificate program among other aspects of the thrift industry, and while their review is not yet complete, the topline is there are some real misgivings as to the participation level and the effectiveness of the program.

Please comment in a more specific manner. Also, given the Federal Home Loan Bank Board has the capability to issue income capital certificates - and in fact does - can this not serve as a substitute for the net worth certificate program? Should the Congress address the issuance of income capital certificates?

The National Council is most familiar with the net worth certificate program as it has been administered by the FDIC. At the outset of that program, 26 savings banks were receiving certificates. Through additions, mergers, and simply an increase in net worth, that number currently stands at 25. Moreover, two of the larger banks in the program will, in all probability, soon be recapitalized by outside investors. Simply stated, these acquisitions would not have happened without the time afforded by the program; the alternative would be much more expensive. So we view the net worth certificates as a success worthy of extension. All the savings banks eligible have participated -- and have benefited.

The situation with savings and loans has been somewhat different. Few eligible institutions have participated and those that have participated had been deteriorating significantly prior to admission. We feel that the FSLIC can make more extensive use of the program than it has and can use net worth certificates in conjunction with income capital certificates.

13. The Committee continues to hear concerns voiced over the proliferation in the investment in high yielding - high risk bonds, the so called junk bonds. Do you feel investment in high yield bonds is a current or potential problem to the thrift industry and should in fact any restrictions or legislative action be considered?

The Council recently concluded a survey of its members on the topic of below investment grade securities holdings. We found that a minority of our institutions hold these securities, and that those who do are holding the bonds of local utilities and other businesses. We feel that the use of these bonds in a general strategy of diversification is useful to our industry and can provide a lift to profitability. To the extent that problems have been identified in this area, they can be handled by regulations in lieu of legislation. Attached is a summary of the survey results and a copy of our letter on this subject to the Securities subcommittee.

14. In your statement you refer to studies commissioned by the Federal Savings and Loan Advisory Council which conclude that savings institutions cannot long survive by investing in long term mortgages. Could you elaborate on these studies? What are the reasons? Who serves on the Council? could you provide the Committee with a copy of these studies?

A copy of the entire document is enclosed, which includes a list of the individual participants.

15. You have expressed concerns that regressive legislation is a serious danger - specifically what proposals do you see being considered which would adversely affect the safety and soundness of our financial system?

Four specific proposals come to mind - three from the bill recently reported from the House Banking Committee and one from S. 2851 of last year.

THRIFT TEST: Last year's House and Senate Banking bills and H.R. 20 this year contain a static, arbitrary asset composition test designed to encourage (or force) S/Ls to revert to the past mode of operation of an over-concentration on originating and holding long term assets while funding these assets with shorter term deposits, the cost of which can change daily. This proposal (given our economic environment and future prospects) can only have adverse effects on the thrift industry.

TANDEM SALES: This provision of H.R. 20 would severely limit savings institutions which operate in a holding company format from competing effectively with financial conglomerate supermarkets such as the Sears Network, Merrill Lynch, and others. For Congress to say that one group of competitors can provide a full range of services but others may not is to doom the latter group to competitive inferiority and atrophy.

FEDERALIZING THE THRIFT INDUSTRY: Sec. 4(e) of H.R. 20 renders the dual banking system null and void with respect to the savings and loan industry.

GLASS-STEAGALL: Last year's House and Senate banking bills included an extension of this 1933 statute to nonmember banks (savings banks) and savings and loans. We still have yet to find what great public threat or abuse or whatever, which calls for such a step. The public interest would be better served by the Act being restudied in light of the modern world of financial transactions rather than simply extended to other institutions.

16. Not many trade associations have applauded Sears' and Beneficial's efforts to broaden consumer choice by providing integrated financial services. However, many are concerned with competitive equity and suggest that bank holding companies be given the right to offer a competitive array of financial services, as Sears and Beneficial. Would you agree?

Absolutely, we agree. We seek no restrictions on our competitors, only to remove restrictions on us and other banking organizations in order that we be able to compete with the diversified financial conglomerates.

17. In your statement you oppose a "thriftness test" which a unitary S/L holding company would have to meet in order to be exempt from the S/L Holding Company Act. One argument that has been advanced for a thriftness test is that, if the nonbank bank loophole is closed, commercial firms can circumvent the closing of that loophole merely by buying a thrift and operating it like a bank. How would you respond?

First of all, the National Council has not supported the various efforts to close the so-called non bank loophole. Secondly, the argument that a savings and loan can be acquired by a commercial firm and run "like a bank" ignores current law. Under the Savings and Loan Holding Company Act, a commercial firm such as General Motors could own one S/L, but only one. Furthermore, by virtue of the Garn-St Germain Act (Sec 335) they can own one only so long as that one continues to qualify under the Internal Revenue Code as a domestic building and loan association. In the event that they "run it like a bank," they lose it or give up their commercial business operations.

Questions for Mr. Colton from Senator Garn - June 18, 1985

1. When Garn-St Germain was passed, some suggested that thrifts would abandon housing. They have not. They seem as committed as ever - originating 54% of all mortgages in 1984. If so, why do we need a stricter asset test? With regard to the Qualified Thrift Lender Test - the U.S. League argues that the holding of liquid assets should not be viewed as an alternative to investment in housing but rather as prudent policy for a housing lender in today's marketplace. If further analysis supports a more flexible qualified asset test so that an institution could safely and profitably maintain its support for housing, would you endorse a more flexible test?

Answers to Senator Garn from Kent Colton - August 27, 1985

1. (a) Currently, tax provisions provide a strong voluntary incentive for thrifts to invest their assets primarily in mortgages. The Administration's tax proposal would abolish favorable tax treatment and thus eliminate the only existing incentive for mortgage investment. A thrift assets test would provide an alternative incentive.

It is premature to say that it has not happened that the thrift industry has reduced their involvement in mortgage lending, as a result of Garn - St. Germain. Three years is a short time in which to determine the trend of a restructuring industry. Still suffering from the earnings crisis of 1980 - 1983, the industry in general lacks the capitalization to take full advantage of diversification.

NAHB is less concerned about the organization of mortgages; it seems that just about anyone can originate mortgages these days. Our sincere concern, rather is thrifts role as mortgage investors. While the secondary markets may thrive in good economic years, many investors abandon mortgages for other securities that may be more attractive in bad years. NAHB has no reason to believe that thrifts would not do the same. The thrift assets test would ensure a continued pool of permanent investors that would ensure a supply of mortgage funds to homebuyers even in difficult economic times.

1. (b) An institution's safety and soundness must be the paramount concern of regulation, and we recognize that profitability is essential to growth of both assets and capital. NAHB, however, does not agree that the experience of 1980 - 1983 makes all mortgage investment unprofitable by definition.

The interest rate risk of mortgages are now not only foreseen, but highly manageable through hedging techniques, portfolio restructuring, adjustable-rate and other alternative mortgage instruments, and GNMAs.

Finally, mortgage-backed securities, which qualify under the assets test, provide liquidity and currently qualify as liquid investments under federal regulation.

2. You testified that 1/2 to 2/3 of all mortgages originated currently end up in the secondary market. Many project this number to increase. If it does and Congresses passes a strict thrift asset test, how will savings and loans be able to comply with it?

2. Again, NAHB is concerned that there be a pool of investors even when mortgages are less attractive than other investments. The thrift assets test does not preclude thrifts from fully participating in the secondary markets. First, thrifts could originate loans far beyond their portfolio requirement, and sell these loans in the secondary markets. Doing so would require relatively few additional funds, and would provide a profit center in terms of origination and servicing fees that would complement the thrift's portfolio management.

Second, the thrift assets test can be met with residential mortgage-backed securities. In other words, thrifts can sell their whole loans, and purchase the securities backed either by those loans or by other loans. The liquidity, yield, and risk diversification offered by mortgage-backed securities would enhance asset management. Indeed, many of the mortgage-backed securities now issued are resold to thrifts.

Third, new financing techniques allow thrifts to keep mortgages on their books while fully participating in secondary market activities. These techniques include collateralized mortgage obligations (CMOs), collateralized preferred stock, collateralized commercial paper, along with pay-through and zero-coupon mortgage-backed bonds.

3. Many thrifts believe that the ability to cross-market other financial services produces real cost savings in marketing, lower prices for the consumer, and new sources of profit for the savings and loan. They argue denying them the right to diversify would only lessen their ability to remain dedicated to housing and residential mortgages. If such revenues add to their ability to originate mortgage loans - are you in favor of prohibiting such activities?

3. The argument that profit from other sources is necessary to keep thrifts in the mortgage lending business is losing validity as thrifts restructure and establish mortgage portfolios that are earning assets. Interest rate management, new mortgage products, and financing techniques discussed above promise continued mortgage portfolio profitability. The profits from other sources, that have been claimed to be essential for thrifts to survive may have been so in the short run in order to counter devastating losses on below-market loans and to recover from 1980 - 1983. NAHB believes that in the long run, mortgage investments will provide consistent and strong earnings performance for well-managed thrifts.

4. With regard to the regulation of government securities dealers, would you explain in more detail why you believe that requiring investors in overnight securities to take possession would unnecessarily add costs to residential mortgages? Would this be true if you required possession by an independent third party agent? If this is too costly why do you believe more expansive forms of regulation would be less expensive?

4. Why requiring investors in overnight securities to take possession would unnecessarily add costs to residential mortgages.

The secondary market for residential mortgages has grown rapidly in recent years and that growth has centered on the mortgage pass-through securities of the Government National Mortgage Association (GNMA), the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). Liquidity and efficiency in the market for these government and related pass-through securities is vital to improving the availability and reducing of cost of home mortgage credit.

The mortgage-backed securities sector is the last area of the securities industry to move from physical delivery of securities to a computerized trading system. Physical delivery and settlement of trades is time-consuming, cumbersome and costly in terms of both increased overhead and delays and errors. The heavy volume of trading in government related mortgage-backed securities created a serious "back office" problem as forms attempted to sort out a huge number of complicated transactions on a monthly basis. This situation sometimes resulted in failed deliveries of securities and provided an environment where abuses of the trading system, such as those that occured at the government securities dealers earlier this year, could occur.

The solution to the problem of improper trading activity, as well as the underlying back office difficulties, is not to require investors in repurchase agreements to take possession of the securities collateralizing these short term loans. Such a system would require more frequent physical delivery of securities and would only compound the paperwork triangle and increase overhead and error expenses.

A better answer is the solution currently being pursued by FNMA, FHLMC and GNMA. FNMA and FHLMC are already employing the Federal Reserve's computerized trading systems to issue new securities and to convert existing certificates to a "paperless" form. GNMA securities still are only in paper form, but the agency has announced plans to employ a depository for its certificates. The certificates would be held in a central location, with all trades between members of the depository recorded on a book-entry clearing system. An added attraction of the proposed GNMA system is the capability to keep track of securities sold under repurchase agreements as well as those that are sold outright.

The implementation of computerized trading should help eliminate the problems encountered earlier this year with the failure of several government securities forms, where the same collateral had been used to back more than one loan. The book entry systems also should speed and streamline the trading process, reducing the cost of overhead, delays and errors. The net result should be a more efficient flow of funds to housing from the capital markets, and a reduction in the cost of residential mortgages.

Questions for Mr. Spiller from Senator Garn - June 18, 1985

1. Mr. Colton testified that one half to two thirds of all mortgages originated currently end up in the secondary market. Many project this number to increase. If it does, and Congress passes a strict thrift asset test, how will thrifts be able to comply?

ANSWER:

1. MBA does not believe that a qualified thrift lender (QTL) test is necessary at this time in light of the continuing commitment of thrift institutions to real estate mortgage lending. If Congress does pass a strict QTL test which excludes or limits the amount of mortgage loans sold in the secondary market that may be counted towards qualifying for the test, such a restriction would greatly hamper the size and liquidity of the secondary market because thrifts would be forced to retain a greater percentage of mortgage loans in their lending portfolios.

   We would urge that in the adoption of any QTL test, that mortgages originated for sale be eligible for inclusion in the test which would recognize the reality that institutions selling loans in the secondary market can supply large amounts of residential mortgage credit through reinvestment of loan sale proceeds into subsequently originated loans. In addition, we would urge Congress to include in any QTL test a "safety valve" provision that would allow the Fed to suspend the application of the test during periods of slow mortgage lending activity, such as during periods of high interest rates.

2. Why should bank and thrift holding companies be given the authority to underwrite and distribute mortgage backed securities?

ANSWER:

2. Bank and thrift holding companies should be given the authority to underwrite and distribute mortgage backed securities (MBS) for a variety of reasons. These institutions currently engage in the underwriting and dealing in U.S. agency MBSs and in doing so have exhibited great expertise in this area. Their impressive track record in the government related MBS marketplace should be considered. Extending this authority to private MBS issues will reduce the cost of these transactions, which must be passed along to the consumer/borrower, by eliminating the significant transaction fees that would otherwise have to be paid for outside underwriting and dealing services. As a result, investors will receive the best price in purchasing MBS underwritten by a private issuer.

In response to the argument that private issuers might engage in self-dealing in underwriting their own securities issues, the key to the successful marketing of private sector issues is the receipt of a high quality rating by an outside, independent bond rating agency, such as Moody's or Standard & Poor's. The presence and significance of such an independent review eliminate the potential for abuse in this area.

3. In his testimony, Doug Timmerman of Anchor Savings and Loan believed that affiliating with a realtor was a natural progression for his company. Do you believe a federal savings and loan should be given the same authority? Why?

ANSWER:

3. MBA believes that federally chartered thrift institutions should be allowed to engage in vertical integration of financial services because increased competition will result in lower prices and more professional services for the consumer. However, any regulation of the product and/or geographic expansion capabilities of these institutions should preserve their safety and soundness.

In response to concerns of anti-competitive behavior that might result from vertical integration as a result of the potential for illegal tie-in arrangements, MBA believes the current anti-trust laws are clear enough in their language and powerful enough in their enforcement remedies (e.g. treble damages) to deter such activity.

4. When Garn-St Germain was passed, some suggested that thrifts would abandon housing. They have not. They seem as committed as ever - originating 54% of all mortgages in 1984. If so, why do we need a stricter asset test? With regard to the Qualified Thrift Lender Test - the U.S. League argues that the holding of liquid assets should not be viewed as an alternative to investment in housing but rather as prudent policy for a housing lender in today's marketplace. If further analysis supports a more flexible qualified asset test so that an institution could safely and profitably maintain its support for housing, would you endorse a more flexible test?

ANSWER:

4. As stated in our response to question number one above, MBA is not supportive of a stricter asset test. As mentioned in question number four, thrifts appear to be more committed to real estate mortgage lending than ever. The recent net worth problems thrifts have experienced are not a result of the use of their expanded powers granted under deregulation, but rather such problems have arisen out of the mismatch of asset and liability interest rate spreads on their balance sheets, particularly during periods of high interest rates.

As mentioned, any QTL test adopted by Congress should be flexible enough to include thrifts' mortgage banking activities because the secondary market is critically important to their operations. In addition, investors are becoming increasingly interested in purchasing MBSs rather than individuals loans due to the increased liquidity of the securitized instrument. As a result, the secondary market, with the aid of MBSs, helps import residential mortgage money to localities that would otherwise suffer a shortage of housing funds.

5. Many thrifts believe that the ability to cross-market other financial services produces real cost savings in marketing, lower prices for the consumer, and new sources of profit for the savings and loan. They argue denying them the right to diversify would only lessen their ability to remain dedicated to housing and residential mortgages. If such revenues add to their ability to originate mortgage loans - are you in favor of prohibiting such activities?

ANSWER:

5. As stated in our answer to question number three, MBA supports increased competition in the financial services industry due to the lower prices and improved services consumers will derive from increased compeititive forces. Mortgage bankers are unrestricted in their ability to cross-market their services into other financial services, subject to state law. MBA would not object to thrift institutions enjoying these same privileges because we maintain that increased competition inures to the benefit of consumers and can help stabilize the thrift industry by broadening these services. Product diversification by these institutions will spread risk and help reduce their vulnerability to adverse financial consuequences that could result from negative market forces impacting upon specific products or marketplaces.

6. With regard to the regulation of government securities dealers, would you explain in more detail why you believe that requiring investors in overnight securities to take possession would unnecessarily add costs to residential mortgages? Would this be true if you required possession by an independent third party agent? If this is too costly why do you believe more expansive forms of regulation would be less expensive?

ANSWER:

6. It is essential to the residential finance industry that the secondary market for residential mortgages run efficiently and smoothly. A secondary market that is liquid is attractive to investors and ensures that transaction costs remain minimal and that new funds constantly flow back to mortgage originators. This keeps the cost of home financing as low as possible.

To require investors in overnight securities to take physical possession of those securities would unnecessarily add costs to residential mortgages because such a requirement would slow the market to the point of virtually shutting it down. Such deliveries would be time consuming and complex and would restrict the availibility of government agency securities for repurchase agreements and would impair the operational integrity of the overnight market. This, in turn, would make it more difficult for dealers to finance government securities positions and would likely impact adversely upon the spreads and yields of the securities.

The suggestion of some to require possession by an independent third party agent would not reduce costs, in fact, it would probably add to them. Banks and other custodians acting in fiduciary capacities charge fees to issuers based upon a percentage of the dollar amount of the securities they are holding on behalf of their principals. These fees would be passed along to the investors dealing in such securities, thus adding to the costs of the secondary mortgage market.

MBA does not believe more expansive forms of regulation are necessary in this marketplace. The abuses that have occurred in this area are aberrational in nature and cannot be regulated against. The response to date to the ESM Government Securities, Inc. and Bevill, Bresler and Shulman failures by the market, investors, state and federal regulators, and dealers has been encouraging. Committee members should note that a depository for Government National Mortgage Association (GNMA) securities is in the process of being developed. MBA, however, urges Congress not to require actual possession of collateral simply based on the existence of this depository. It is a private venture operated by the Mortgage Backed Securities Clearing Corporation (MBSCC), which is a subsidiary of the Midwest Stock Exchange, Inc. It began operation in pilot form on March 25, 1985, with seven participants. While there is no definite time frame, eventually most participants in the GNMA securities market will be eligible to participate in MBSCC, including registered broker/dealers, commercial banks, thrift institutions, and mortgage bankers.

The CHAIRMAN. Next I'd like to invite Mr. Robert A. Hess, manager, Wright-Patman Congressional Federal Credit Union; and Joseph Perkowski, manager and treasurer, Minneapolis Federal Employees Credit Union of Minneapolis.

Mr. Hess, would you like to begin?

STATEMENT OF ROBERT A. HESS, MANAGER, WRIGHT-PATMAN CONGRESSIONAL FEDERAL CREDIT UNION, WASHINGTON, DC, TREASURER, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. HESS. Mr. Chairman and members of the committee, my name is Robert Hess. I am treasurer of the National Association of Federal Credit Unions, and manager of the Wright-Patman Congressional Federal Credit Union. NAFCU appreciates the opportunity to appear before you this morning.

Mr. Chairman, we have submitted a comprehensive statement concerning a variety of issues. However, in the interest of time, I will address the single issue that has the potential for fundamentally altering the very character of our Nation's member-owned credit unions—taxation.

Congress chose to exempt credit unions from taxation in order to establish a system of low-cost financial services to consumers. For more than 50 years, Federal credit unions have remained committed to that mission. In fact, the last Congress passed a resolution affirming that credit unions today are no different than they were when initially chartered.

TAXATION OF CREDIT UNIONS

The President's tax proposal would levy Federal income tax on credit unions with assets of $5 million or more. It would tax 80 percent of all credit union retained earnings. Thus, the issue is: Can these member-owned, nonprofit cooperatives remain viable if they are subjected to this or any other proposed tax?

Proponents of the President's taxation proposal say that credit unions hold a competitive advantage over other financial institutions. If this were so, credit unions, which outnumber banks and thrifts combined, would hold most of the consumer credit and deposits across the board. In fact, credit unions hold only 14.9 percent of installment credit and only 5.2 percent of savings deposits. The credit union success stems from the fact that we provide basic financial services for our members at the lowest possible cost and at places that are convenient.

A clear distinction between credit unions and other providers of financial services is found in the manner in which credit unions insure their members' accounts. As a result of actions initiated in this committee last year, all federally insured credit unions now place an amount equal to 1 percent of their insured shares in the National Credit Union Share Insurance Fund. The Share Insurance Fund is now the strongest of the three Federal deposit insurance funds. In addition, by capitalizing the fund in this way, credit unions reduced the Federal deficit by almost $800 million—8 percent of the deficit reduction achieved in 1985. Our contribution to deficit reduction will continue year after year, as credit unions in-

crease their insurance deposit to reflect growth—growth which could be stunted or even reversed if the plan to tax credit unions were enacted into law.

Credit unions are different because we are cooperative associations of people helping people. We keep our costs low because we depend heavily on the services of volunteers. Boards of directors of credit unions, as such, serve without compensation. More than 250,000 volunteers serve our Nation's credit unions.

It is also said that credit unions have grown disproportionately from other classes of financial institutions. However, the General Accounting Office has noted that 99.5 percent of Federal credit unions have assets of less than $100 million. The GAO concluded that, "* * * overall, credit unions are not a serious competitive threat to * * * (their) taxed competitors."

Despite what the GAO said, some hold that the larger credit unions are substantially equivalent to commercial banks and thrifts. This assertion is untrue. All credit unions, regardless of size, serve a well-defined, limited field of membership. Our philosophy of operation makes us distinctly different from other financial providers.

The President's proposal would tax over 80 percent of credit union retained earnings while exempting small credit unions from taxation. By establishing a system that would exempt small credit unions, a strong disincentive for these institutions to provide necessary services would be built into the Tax Code. Of particular concern to the members of this committee should be the impediment this would present for the NCUA board if it were to seek a merger partner for a troubled credit union. Few credit unions would be willing to merge if the consequences were taxation. Even more troublesome, some credit unions would adopt tax-avoidance strategies that might well affect their safety and soundness. As the members of this committee may recall, in February last year, the then chairman of NCUA stated unequivocally that "the taxation of credit unions could seriously affect their financial soundness." Surely Congress would not wish that result.

It is a fact, Mr. Chairman, that credit unions' reserves are their only source of funds for assuring safety and soundness. In justifying his proposal the President goes to some length to note that: "In 1983, Federal credit unions * * * retained earnings * * * were 10.6 percent of current net earnings." Proponents of credit union taxation imply that such a transfer to retained earnings is excess or even improper. Yet, the Federal Credit Union Act itself requires that 10 percent of operating income be placed in reserves until prescribed percentage levels of outstanding loans and risk assets are reached.

STUDY SHOWS DETRIMENTAL EFFECTS

A NAFCU study shows that perhaps as few as one-third of all Federal credit unions could maintain their present statutory reserve levels even in the initial period if the President's tax proposal were to become law. As you are painfully aware, Mr. Chairman, undercapitalization of any financial institution is the root cause of insolvency.

Particularly bothersome to the credit union community is the fact that the administration and others are willing to cast the pall of uncertainty over credit unions for so little revenue gain when measured against the inevitable hardships. Clearly, credit union members across the spectrum would suffer. Mr. Chairman, in the credit union that I manage, the Wright-Patman Congressional Federal Credit Union, the preliminary estimates of the effects of the President's tax proposal are unsettling for our members. Just considering the initial impact on our reserves, we have projected that loan rates might have to be raised or share dividend rates reduced, or service fees imposed on nonfee services and existing fees increased.

And what would all of this generate? By administration estimates, not more than $200 million in fiscal year 1986. By our own calculations, the actual gain in revenues by taxing Federal credit unions would be less than $80 million.

As President Reagan said in announcing his tax proposal to the Nation, "The power to tax is the power to destroy." The credit union community poses the obvious question: Where is the common good in a taxation philosophy that could destroy the soundness of self-help, member-owned financial cooperatives that benefit over 50 million consumers?

In conclusion, Mr. Chairman, the credit union community speaks with a single voice. Both the National Association of Federal Credit Unions and the Credit Union National Association have launched a concerted shouider-to-the-wheel effort to defeat taxation of credit unions. We are unalterably opposed to any tax on any credit union, regardless of size.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

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Statement of Robert A. Hess

Treasurer

National Association of Federal Credit Unions

Before

The Senate Committee on Banking,

Housing and Urban Affairs

On

Changes in the Financial Services Industry

June 18, 1985

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Mr. Chairman and members of the Committee, I am Robert A. Hess, a member of the Board and Treasurer of the National Association of Federal Credit Unions. I am also the manager of Wright Patman Congressional Federal Credit Union. The National Association of Federal Credit Unions is the only national organization exclusively representing the interests of credit unions chartered by the federal government.

NAFCU commends you, Mr. Chairman, for your stewardship in pursuing a legislative response to the many changes confronting the financial services marketplace. We appreciate the opportunity to contribute to that dialogue and to participate in the shaping of proposals that will be the focus of your Committee's actions in the coming months.

Mr. Chairman, we are especially appreciative of the concern you have demonstrated when addressing issues of importance to credit unions. As a result of your efforts and those of this Committee, we are able to say with pride this year that credit union savings are backed by the strongest of the federally administered deposit insurance funds. The only financial institution legislation to pass both houses of Congress last year was initiated in this committee as S. 2522 and was agreed to by the House as part of the Deficit Reduction Act of 1984 (P.L. 98-369). I will discuss the significance of this achievement in more detail later in this statement.

Beyond our recent legislative successes, however, there remain numerous issues confronting the credit union movement which will have a profound effect on our future. Some of these issues were addressed in S. 2851, the legislation approved by the Senate last year. Other issues have not yet been brought before the Committee, and still others fall outside your jurisdiction yet deserve the Committee's attention. In fact, the issue of paramount importance to the credit

union movement is one which is not likely to come before this Committee, unless you, Mr. Chairman, request joint referral on the subject. The subject to which I refer is that of taxation of Federal credit unions. If the tax exemption for credit unions is repealed, we fear that it could well spell the demise of the credit union movement in this country. That decision could affect the financial lives of more than 50 million individuals. Because of the many profound policy issues taxation of credit unions involves, I urge you in the strongest possible terms to request such joint referral.

Credit Union Taxation

The tax exemption of Federal credit unions dates to the beginning of the Federal credit union movement in the 1930s. Our objective in the current debate on tax reform is to convince the Congress and the Administration that the tax exemption should be retained. If we are successful, over five decades of growth and progress in the Federal credit union movement can go forward, unabated.

There are approximately 10,500 Federal credit unions in the United States, representing 27.5 million members. At the end of 1984, state and Federal credit unions together held less than 5.5 percent of the small time and savings deposits in financial organizations.

Evolution of Credit Unions' Tax-Exempt Status

Since the 1860s, the tax laws at the federal level have almost uniformly recognized that cooperatives and other non-profit institutions should be treated differently from profit-making entities. The law makes this distinction by taxing the distributions of non-profits primarily at the membership level — de facto recognition that the institutions are merely extensions of their

members. This distinction has been ever-apparent in the case of credit unions, since they have always operated on a non-profit basis, and since they have membership and service restrictions that limit their competitive stance with other financial organizations.

The tax-exempt status of state-chartered credit unions was recognized in a 1917 opinion of the Attorney General of the United States, and was formally conferred in the statutes by the Revenue Act of 1951. The charter act for Federal credit unions, the Federal Credit Union Act of 1934, as amended, granted a full federal tax exemption to Federal credit unions in 1937, and that exemption is the law today. (A comprehensive review of the history, rationale and outlook for the tax exemption of Federal credit unions is attached as Appendix A.)

Provisions of Current Tax-Simplification Proposals

Three of the major tax-reform proposals now in the Congress would remove the tax exemption historically granted to credit unions. Specifically, S. 409/H.R. 800, introduced by Senator Bill Bradley (D-NJ) and Congressman Dick Gephardt (D-MO); S. 321, by Senator Dennis De Concini (D-AZ); and the President's tax reform proposal, recently transmitted to the Congress, would repeal the credit union tax exemption. S. 1006/H.R. 2222, introduced by Senator Bob Kasten (R-WI) and Congressman Jack Kemp (R-NY), would retain the tax exemption for credit unions because the sponsors feel strongly that credit unions are unique financial institutions whose non-profit status justifies their current tax treatment. NAFCU has recently received written reaffirmation of support from Senator Kasten and Congressman Kemp on the tax issue.

Proponents of repeal, on the other hand, base their arguments on the issue of equity: the need to treat financial institutions alike for tax purposes so

that one group does not enjoy either an economic or competitive advantage over another. This argument fails to consider that other financial organizations, such as banks and savings and loans, operate in the open marketplace to the benefit of their stockholders. By contrast, credit unions serve only their own fields of membership and function for the sole benefit of their members. There is no separate class of owners in a credit union — the members own all of the assets — and there is, therefore, no profit motive. Members pay federal taxes on their dividends — as is the case with other cooperatives.

Unique Volunteer Aspect of Credit Unions

A central feature of the credit union movement is the substantial volunteer effort at both the board-of-directors level and at the operating level — a feature not found in other financial organizations. This spirit of volunteerism and the strong community orientation of credit unions go hand in hand. By law, board members, except for a single member, serve on a volunteer basis without compensation. At the present time there are over 250,000 volunteers in the credit union movement. In fact, at least one-third of the approximately 18,500 credit unions in the nation have no full-time employees. They carry out their financial services with volunteers for the most part.

At first glance, one might say that taxing credit unions would not disrupt this historical community connection in the credit union movement; but as a result of taxation we foresee pressures developing to compensate directors and other volunteers. In that eventuality, an important, albeit intangible, quality in the credit union community would be lost. Moreover, many credit unions would be devastated financially if they were required to compensate their volunteer

officers and support personnel. Across the credit union spectrum, these volunteer services are estimated to be worth some $200 million in this calendar year.

Safety and Soundness

Another major concern of the credit union movement over taxation is the effect on safety and soundness — two fundamental elements of the credit union philosophy. Unlike stock-issuing financial institutions — such as banks and savings and loans — the ownership of credit unions is reflected in members' holdings of shares (savings) in the credit union. Therefore, there is no source of capital other than retained earnings to provide for contingencies and for expansion. These reserves in the credit union serve several needs, Mr. Chairman: (1) they are the source of funds for assuring that the credit union meets the statutory requirements for reserves sufficient to cover loan losses and non-productive investments; (2) they allow credit unions to keep pace with the rapidly changing technological requirements of the financial services industry; and (3) they provide the margin for growth capital needed to keep credit unions on par with the needs of their members. While the effects of taxation on credit unions' equity would differ under each of the bills now before the Congress proposing the taxation of credit unions, the studies done within the credit union community estimate the impact on equity to be considerable.

The President's Proposal

In the latter connection, the President's recent tax-reform proposal serves as an example of the clouded financial outlook for credit unions if their tax exemption is repealed. (See Appendix B)

The President proposes to tax only credit unions with assets of $5 million or more. But, using December 31, 1984, figures, that represents 85 percent of Federal credit union assets, or about $54 billion. Beyond this, the President's plan would stifle credit union growth. Consider, for example, that credit unions below the $5 million threshold would have a strong incentive to deter an increase in their assets — because once that dividing line was breached their entire amount of transferable reserves would be subject to tax. From the other perspective, larger credit unions would, in effect, be penalized for their efforts to develop and expand on behalf of their members.

None of this is conjecture on our part, Mr. Chairman. Recently, NAFCU asked its credit union financial consultant to project the financial effects of the President's tax plan on six representative credit unions among NAFCU's membership. The results showed that in the first year, alone, the credit unions' net reduction in income transferred to reserves would average almost 40 percent. Even more devastating, only one of those six representative NAFCU-member credit unions would have been able to maintain the 10 percent payment to reserves required by law and by regulations of the National Credit Union Administration. (See Appendix C)

Other Effects of Taxation

There are other equally troublesome scenarios that would likely follow taxation of credit unions. For example, credit unions might consciously look for ways to reduce their taxable income or to maximize profits through resort to speculative investments. The President's proposal, in its analysis of the recommendation to tax credit unions with assets of $5 million and over, states

that "...large credit unions would have to increase the spread between their 'dividend' rates and loan rates...." However, was any consideration given to the effects of such a policy on credit union members? For example, in the credit union that I manage, the Wright Patman Congressional Federal Credit Union, there is a clear indication that the President's proposal would cause an upward tick in loan rates, or a decrease in share dividend rates, or an increase in service fees all within the initial throes of taxation. Clearly, this situation would be repeated in most cases throughout the credit union community.

Moreover, there is a strong likelihood that boards of directors would pay out, as dividends, reserves needed for expansion — as a means to avoid taxation. (See Appendix D) This was the tendency on the part of mutual savings institutions in the United States following removal of their tax exemption in 1951, and of credit unions in Canada when they were taxed. Eventually, credit unions would lose their identity and would, of necessity, become more like banks and savings and loans. Even in this case, only the strongest and fittest credit unions would be able to compete with the other classes of financial institutions. Mr. Chairman, this is a particularly ironic scenario. At a time when the chairman of one of the largest financial networks in the country calls for the establishment of "family banks" to better serve the needs of consumers, credit unions are being earmarked for changes that would erode forever their strong commitment to providing low-cost financial services to consumers of average means.

Credit Unions' Contributions on the Deficit

Turning now to the intertwined issues of taxation and the deficit, credit unions believe that there is a substantial economic argument to be made for

maintaining their present tax exemption. Historically, credit unions have paid maximum dividends to their members, after making provisions for statutory reserves, and all such dividends are, of course, taxable at the membership level. By paying out most of their earnings as taxable dividends, credit unions have consistently provided the maximum possible savings return to members after setting aside statutory reserves necessary for safety and soundness of operations, and small, prudent reserves needed for member services.

As I alluded earlier, Mr. Chairman, the action initiated by your Committee attendant to the implementation into law of the Deficit Reduction Act of 1984 strengthens the argument that credit unions do their part in contributing to a sound national economy. On January 21, 1985, all credit unions with Federal insurance were required to deposit with the National Credit Union Share Insurance Fund (NCUSIF) in the Treasury an amount equal to 1 percent of their insured shares. This requirement has as its long-term purpose the building of the reserves of the Fund; but its short-term effect was to reduce the FY 1985 budget deficit by almost $800 million. These funds are a significant part of the additional monies raised to combat the deficit in this fiscal year. In fact, figures from President Reagan's 1986 budget indicate that credit unions contributed 8 percent of the revenue expected to be gathered in FY 1985 by the federal government under the authority of the Deficit Reduction Act.

This firm, cooperative action by the Congress and the credit union community shows the support of credit unions for sound economic initiatives. But credit unions must also keep pace with the times in order to serve their members. Taxing credit unions' reserves would reduce the source of growth capital and thus inhibit their ability to keep pace with the needs of their members.

Particularly bothersome to credit unions is the push by the Administration, and others, to risk the future financial health of credit unions for clearly questionable fiscal gains.

Although the Treasury estimates that taxing credit unions with assets of $5 million and above would yield $200 million of additional revenue in FY 1986, independent studies within the credit union community show that the actual increase might be less than half that figure. This variance stems from tax-planning efforts on the part of some credit unions; reduced growth brought on by the altered competitive stance of credit unions vis-a-vis other financial institutions; and the inevitable push to compensate the 250,000 volunteers that now donate their time to the credit union movement. Mr. Chairman, there is no economic logic, in our view, in risking the viability of the credit union movement for, at best, a marginal increase in federal revenues.

Credit Unions Are Unique

We believe that credit unions' place in the structure of the financial services industry would be adversely affected if the current proposals in the Congress to tax credit unions were enacted. Their special niche as providers of low-cost financial services to individuals of modest means would be in jeopardy; indeed, we envision that many credit unions would not be able to pay a sufficient return on savings to enable them to effectively meet their statutory mandate to promote thrift.

Mr. Chairman, both the National Association of Federal Credit Unions and the Credit Union National Association have launched a concerted "shoulder-to-the-wheel" effort to defeat taxation of any credit union, regardless of size. Together, we represent virtually all of the more than

18,500 credit unions across this nation. Our view is that credit unions are unique cooperatives and that they do not seek and must not be forced into direct competition with commercial organizations. Credit unions are special financial cooperatives for many reasons: they play an important role in the lives of employees at their work sites; they serve senior citizens and other similar groups of individuals within their associations; and they make important contributions to inner-city residents and to rural inhabitants who may not have other financial-service options available to them.

Mr. Chairman, the credit union community has, in the past, done its part in helping to achieve the economic goals of our country. Credit unions can be counted on to continue down that path — not only because they have a responsibility to the nation as a whole but because, in the final analysis, programs and policies that have a truly positive impact on America's capacity to produce goods and services efficiently and fairly will improve the well-being of all Americans. In speaking out on taxation, credit unions ask only that those in the Congress and the Administration who are proposing to tax credit unions look at all the facts. After such a review, we are confident that impartial lawmakers will reject all proposals to tax credit unions, regardless of size, and conclude that such a change would needlessly and perilously reverse decades of progress in the evolution of our nation's financial-services structure.

Credit Union Amendments

While the issue of taxation is one which has currently captured much of the attention of the credit union community, there remain others which come more directly under the jurisdiction of this Committee that will also have a signifi-

cant impact upon credit union operations. Several of these issues were addressed by this Committee in the legislation it approved last year.

Title II of the Financial Services Competitive Equity Act (S. 2851) which passed the Senate last year contained seven provisions, all of which were directly related to credit unions. For the benefit of the committee I will briefly review each of the provisions of Title II.

Second Mortgage Authority

The first provision, Section 201 of the legislation, would have authorized the NCUA Board to allow Federal credit unions to make second mortgages for periods exceeding 15 years. This was intended to restore language which was inadvertently deleted when Congress adopted the Garn-St Germain Depository Institutions Act of 1982 (P.L. 97-320). Last year, as part of the Housing and Community Development Technical Amendments Act of 1984 (P.L. 98-479), Congress agreed to give the NCUA Board the authority to allow federal credit unions to make home improvement loans of up to 15 years maturity. This legislation did not, however, mirror the language that was approved by this Committee and the full Senate last year.

While the legislation adopted by Congress last year goes far toward enabling Federal credit union officials to remain responsive to the needs of the marketplace, it lacks the flexibility needed to allow credit unions to better serve the financial needs of their members. By authorizing NCUA to allow second mortgages to be made for periods of longer than 15 years, credit unions that offer variable rate loans would be given the option of extending the repayment period instead of requiring larger periodic payments or a balloon payment at the end of 15 years. Recognizing the potentially beneficial attributes of these

loan arrangements, NAFCU continues to support the language governing 15-year second mortgages that was originally approved by this Committee and the Senate last year.

Faithful Performance

Section 202 of last year's bill would remove the current "faithful performance" bond requirement for Federal credit union financial officers, and replace it with a requirement for "adequate fidelity coverage." NAFCU expressed reservations about this provision during last year's hearings. We are concerned that the language may be as confusing as the current "faithful performance" standard, and we think "adequate fidelity coverage" warrants further definition. We would encourage the committee to provide furthur instruction on levels of coverage necessary to protect the volunteer officers of the credit union as well as the interests of the credit union membership.

Membership Officers

Section 203 of S. 2851 would allow the membership officers of a credit union to be chosen from the members at large, rather than from the credit union's board of directors. This language was intended to correct a technical error contained in the Garn-St Germain Act. NAFCU continues to strongly support this technical correction.

Fidelity Coverage

NAFCU remains unopposed to the provision contained in Section 204 that would require the board of directors of a credit union to provide adequate fidelity coverage for officers and employees that have custody of or that handle funds; however, as mentioned previously, the phrase "adequate fidelity coverage" should be more clearly defined.

Non Participation

Section 205 of last year's bill would allow a credit union to expel a member by either a two-thirds vote of the members or by a majority vote of the board of directors. This section simply clarifies a provision added by the Garn-St Germain Act on expulsion of members because of non-participation in the credit union. The language clarifies the alternatives available to the credit union. While expulsion is an action of last resort for credit unions, it is important that such an option be available. NAFCU continues to support the language as adopted by the Senate last year.

Insurance Conversion

Section 206, approved as part of the credit union title of S. 2851, would have eased the membership voting requirements for state-chartered credit unions to withdraw from NCUSIF coverage in favor of state insurance. We understand that this amendment is no longer being considered for inclusion in this year's legislation. Since NAFCU strongly opposed Section 206, we are pleased by this recent development. We strongly support mandatory federal share insurance for all Federal credit unions. We also believe federal share insurance should be available to all qualified state-chartered credit unions.

Conservatorship Authority

We support the language contained in Section 207 of last year's bill which would make permanent the temporary three-year grant of conservatorship authority Congress conferred upon the National Credit Union Administration Board in 1982 with passage of the Garn-St Germain Depository Institutions Act of 1982. This authority allows the agency to appoint itself conservator of an insured credit union if, in its judgment, such action is necessary to protect

against a dissipation of the assets of an insured credit union. Use of such authority would generally be invoked to protect a credit union's members, creditors and the National Credit Union Share Insurance Fund. In the absence of further legislative action, NCUA's conservatorship authority will automatically expire on October 15, 1985.

Usury Ceiling

Another important provision approved by the Senate last year would have eliminated the statutory loan rate ceiling now placed on Federal credit unions and permitted each board of directors to decide for themselves what rate of interest they should charge for their loans. We have staunchly supported such legislation for a number of years, and would urge the Committee to give favorable consideration to such a provision again this year. Currently, Federal credit unions are the only federally-chartered institutions that have a federally-imposed consumer loan rate ceiling. Federal credit unions were the first group of traditional depository institutions to be deregulated on the liability side, as NCUA deregulated share accounts in March, 1982. We have adjusted well as the statistics show. The record of Federal credit unions is clear. They traditionally have set loan rates below the statutory limit whenever possible. In this era of deregulation, Federal credit union boards of directors should be allowed to make this important decision regarding the asset side of the balance sheet as well. We are hopeful that Congress will remove the loan rate ceiling this year.

Interest on Reserves

An additional provision which NAFCU encourages the Committee to include in this year's legislation is a requirement that the Federal Reserve make interest

payments on certain reserves. Although this provision was deleted during the Senate's consideration of S. 2851 last year, NAFCU urges this Committee to incorporate a similar provision in this year's legislation.

As a result of the "Depository Institutions Deregulation and Monetary Control Act of 1980 (P.L. 96-221), Federal credit unions which exceed a $2.8 million threshold of transaction accounts and non-personal time deposits are required to place reserves against money market deposit accounts or their equivalents, including money market share accounts. NAFCU has supported the payment of interest on all Regulation D reserves for a number of years. The requirement that credit unions hold their reserves in a non-interest-bearing pool imposes an implicit tax upon the credit unions which operates to the detriment of their members. The burden of sterile reserves reduces the dividends which credit unions are able to return to their members and forces them to charge more for loans. For the benefit of credit union members, we strongly urge the Committee to adopt legislation again this year which would require the Federal Reserve to pay interest on Regulation D reserves.

Deposit Availability

Through S. 2851, this Committee addressed a problem of growing magnitude in this country — anti-consumer policies by some financial institutions. Title VI of S. 2851, The Fair Deposit Availability Act, was directed toward problems arising from check-hold policies and the crediting of interest on deposit accounts.

NAFCU commends this Committee for its attentiveness to the needs of consumers in this country. In light of the well documented problems regarding this issue, we understand and support the Committee's efforts to correct the

anti-consumer policies of certain unscrupulous financial institutions. We do, however, question whether credit unions need to be included in the coverage of this provision.

As member-owned cooperative institutions, credit unions are the financial institutions which are most responsive to the needs of their members. This sentiment was recently documented in a survey reported by The American Banker. That poll revealed that credit union members are generally more satisfied by the level of services they receive from their credit union then those available from all other financial institutions. The credit union community is very pleased by these findings, and we believe that they are indicative of the special nature of credit unions.

In addition to a high level of member satisfaction, there is little indication that credit unions are guilty of the types of activities which spurred this Committee to incorporate Title VI into S. 2851. Nevertheless, we believe increased disclosure will help financial institutions understand their obligations with respect to their depositors and will lessen the possibility of problems arising from the lack of information to consumers. Other than providing next-day availability for Treasury checks, we would oppose any provision which would establish rigid guidelines for crediting deposits to accounts made on various classes of checks. As volunteer-dependent institutions, many credit unions rely upon other financial institutions for their check-clearing services. Such credit unions would have difficulty complying with a regulation that required accounts to be credited within a certain number of days since they could not independently determine whether a given check had actually cleared. We support the Committee's efforts toward improving the check-clearing system.

Brokered Deposits

NAFCU strongly supports legislation the Committee adopted last year with respect to brokered deposits. By limiting the aggregate amounts of brokered deposits which may be accepted by financial institutions, the Committee prudently limited the risks posed to the FDIC and the FSLIC—without infringing upon the very necessary and appropriate operation of money brokers in the financial marketplace.

Beyond the many issues of importance to credit unions which this Committee addressed in last year's legislation, there remain several issues which NAFCU would like to bring to the Committee's attention.

Authority for Federally-Insured Credit Unions to Redeem Food Stamps

Due to their mission as providers of financial services to individuals of moderate means, credit unions often are available to groups which are not served by commercial financial institutions. Nowhere is this commitment more evident than in many of our center-city areas where credit unions remain as the sole providers of financial services to entire neighborhoods.

Despite their dedication to their communities, credit unions are prevented from meeting one fundamental financial need, that of redeeming food coupons. As a result of the Food Stamp and Commodity Distribution Amendments of 1981 (P.L. 97-98), only federally-insured banks and savings and loan associations may redeem food stamps. NAFCU strongly supports extending parallel treatment to federally-insured credit unions as provided for in S. 555, introduced by Senator Cranston on February 28, 1985.

Although NAFCU does not anticipate that many federally-insured credit unions would avail themselves of this authority, it will enable those credit unions in impoverished areas to better serve the needs of their field of membership.

Community Development Credit Unions

Mr. Chairman, a little known yet tremendously valuable segment of the credit union movement in this country is community development credit unions (CDCUs). Historically, these entities have been formed to provide credit union services to communities lacking in financial services. Community development credit unions have been supported in their efforts by the federal government which, through the operation of a $6 million revolving loan fund, has supplied seed capital for the establishment of these credit unions. Despite the modest federal contribution, it has been an essential element in the success of community development credit unions in this country.

Today, however, the continued development of CDCUs is in question. As part of his budget submission, the President has proposed that the authority for the revolving loan fund be eliminated, and that the unobligated balances be transferred to other programs. Community development loans are currently administered by the Department of Health and Human Services.

Because of their well established history of bringing financial services—lifeline services if you will — to deprived communities, we urge you, Mr. Chairman, to convey to your colleagues on the Budget Committee the value of this program. We believe that the budget authority for the CDCU revolving loan fund should be retained and that the responsibility for administering this fund

should be transferred to the federal agency primarily involved with the regulation and development of Federal credit unions. That agency is the National Credit Union Administration.

Federal Credit Union Exemption From The Federal Trade Commission

When the Federal Trade Commission Act was enacted in 1914, banks were specifically exempted from the direct regulatory and investigative authorities of the newly-created Commission because they were already regulated by the Federal Reserve Board. Savings and loan associations were granted a parallel exemption in July 1979, by the enactment of Public Law 96-37. Today, Federal credit unions are the only type of federally-chartered depository institution directly regulated by the Federal Trade Commission.

As you and your colleagues in the Congress consider legislation to reauthorize the Federal Trade Commission (S. 1078), we respectfully request that you support language retained in Section 11 of that legislation which, if enacted into law, would provide an exemption for Federal credit unions from direct Federal Trade Commission jurisdiction. Such an exemption has been favorably reported by the Senate Commerce Committee in the 97th Congress, the 98th Congress, and the 99th Congress.

The precedent for exempting Federal credit unions from direct Federal Trade commission jurisdiction is well established. In addition, such an exemption would eliminate unnecessary, costly, and duplicative regulation of Federal credit unions. NAFCU suggests that the National Credit Union Administration, which is the independent agency of the federal government with primary responsibility for the chartering, regulation, supervision, and examination of Federal credit unions, should regulate Federal credit unions with respect to consumer protection matters and most areas of antitrust, rather than the FTC.

Earlier this year the Chairman of the Federal Trade Commission and the Chairman of the National Credit Union Administration Board joined us in stating their clear support for this exemption when the legislation was considered and approved by the Senate Commerce Committee.

Elimination of Separate Form 1099 Mailings

On behalf of the Federal credit union community, NAFCU urges the Congress to support our efforts to provide relief from the costly and burdensome requirement of mailing separate Form 1099's to our members. The costs associated with complying with the separate Form 1099 mailing requirement are extensive, both to credit unions and their members. The benefit to the Internal Revenue Service in its effort to assure greater taxpayer compliance is apparently minimal. Of course, the unnecessary cost to our economy is multiplied many times, since virtually all payors of interest and dividends are subject to the onerous separate Form 1099 mailing requirement.

Let me assure you the NAFCU encourages full and total compliance with our tax laws. Documentary evidence already exists which clearly indicates that the level of voluntary compliance with our tax laws as they relate to interest and dividend reporting was extraordinarily high prior to imposition of the separate Form 1099 mailing requirement. In July of 1981 the Internal Revenue Service released a report entitled "Study of the Information Returns Program (IRP) TY 1975 and 1976." This IRS study is significant because it constitutes an acknowledgment by the Treasury Department itself that, at least for the years studied, taxpayers voluntarily reported 96.7 percent of all interest and dividends for which information returns were filed.

If the IRS study correctly asserts that there was a 96.7 percent compliance rate on the payment of taxes on interest and dividends for which information returns were filed, then it seems clear that the present requirement for a separate mailing is neither an effective nor efficient method of achieving optimum compliance.

Regulatory Simplification

When Congress enacted the Depository Institutions Deregulation Act of 1980 (P.L. 96-221), it contained in Title VIII the Financial Regulation Simplification Act of 1980. That straightforward measure required the federal financial regulators, including the National Credit Union Administration, to insure that their regulations actually are necessary and that the public and other interested parties are given an opportunity to air their views on proposed regulations. The measure also required agencies to consider various alternatives during the rule-making process. It gave clear instructions to the agencies that the costs and burdens of federal regulation are to be minimized; that regulations be written clearly and simply; and that conflicts, inconsistencies and duplications be avoided.

The Financial Regulation Simplification Act of 1980 had an automatic sunset provision that caused the law to expire five years after enactment, on March 31, 1985. NAFCU would encourage the members of this Committee to include language restoring the Financial Regulation Simplification Act in whatever measure finally emerges this Congress.

Conclusion

Mr. Chairman, as we stated at the outset, the National Association of Federal Credit Unions appreciates the opportunity to appear before this commit-

tee to express our views on issues confronting the credit union community. We come before this Committee deeply concerned that the future of credit unions in this country will be seriously jeopardized if the tax treatment historically accorded them is reversed. We urge the members of this Committee to carry that message to your colleagues in the Senate, and we look to you, Mr. Chairman, to once again assist us in preserving the exemption from federal taxation to which all credit unions are entitled. Thank you.

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THE TAX EXEMPTION OF FEDERAL CREDIT UNIONS

Its History, Rationale and Outlook

RESEARCH REPORT

Published as a member service by the National Association of Federal Credit Unions

EXECUTIVE SUMMARY

FRESH LOOK AT EXEMPTIONS

In the course of an extensive examination of the nation's fiscal policy, the Administration and the Congress are reviewing the tax laws with an eye to their reform and simplification. A fundamental part of this scrutiny is a fresh look at the tax preferences historically granted to financial organizations.

The Treasury Department published a comprehensive tax-reform proposal in November 1984 and recommended that the tax exemption for credit unions be removed in the interest of maintaining even-handed tax treatment of all financial organizations. The President's tax-reform proposal, a revised version of the Treasury plan, was submitted to the Congress on May 29, 1985; it recommends that federal taxes be levied on credit unions with assets of $5 million or more. In the 99th Congress, several other tax-reform proposals have been introduced; many of these proposals would remove the current tax exemption for credit unions.

COOPERATIVES HISTORICALLY GRANTED TAX PREFERENCES

From the time of the Civil War, the nation's tax laws have generally treated cooperatives and other non-profit organizations as extensions of the membership of these organizations. Thus, their earnings are taxed when they pass to the members in the form of dividends.

Credit unions, both state-and federally-chartered, have held federal tax exemptions, for the most part, since their beginnings. Other formerly tax-exempt financial institutions, such as mutual savings banks, lost their tax preferences as their membership orientation became a less distinct part of their organizational make-up.

SUPPORT FOR RETENTION

Despite the existence of significant momentum to remove tax preferences, there are many influential Members of Congress who favor keeping the tax exemption for credit unions in place. They have looked at the issue from both its historical perspective and in the context of the current debate on fiscal-policy reform, and have concluded that:

- Credit unions are different, organizationally, from other financial organizations; they are cooperatives with restricted memberships and they are totally consumer-oriented.
- Credit unions are non-profit institutions; their earnings are taxed at the membership level as share dividends.
- Credit unions have statutory limitations that restrict the range of their operations.

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* Credit unions depend heavily on the work of volunteers for their boards of directors and at the operating level.

OUTLOOK FOR TAXATION

Although a proposal to tax the earnings of credit unions surfaced as far back as the Carter Administration, the first clear effort to remove the tax exemption is taking place in the current Congress as a part of the movement for tax reform.

While the course for major changes in tax policy is obscured by the ongoing struggle over deficit reduction, recent events indicate that there is considerable impetus within the Administration and the Congress for moving the issue front and center. Hearings are continuing in the House Ways and Means Committee, and the Senate Finance Committee is moving swiftly to craft proposed legislation from the President's recent proposal.

CREDIT UNIONS WILL BE ACTIVE

Most of the legislators who are familiar with the credit union taxation issue predict an uphill struggle for credit unions in retaining their tax exemption. Credit unions will, therefore, voice their concerns about taxation so that the Administration and the Congress will be fully aware of where the credit union community stands on the issue. Credit unions will keep the lines of communication open with members of Congress by taking part in Congressional hearings and by discussing the issue with their Congressional delegations.

In all of these activities, credit unions will be asking the Congress to give careful consideration to all aspects of the taxation issue, and to consider the unique role that credit unions play in providing low-cost financial services to individuals of modest means. This paper carries the substance of the credit union message.

QUESTIONS OR COMMENTS

If there are questions or comments about any of the material in this paper, please send them to James T. Spahr at the National Association of Federal Credit Unions, P.O. Box 3769, Washington, D.C. 20007. NAFCU can be reached, toll-free, from phones outside Virginia on (800) 336-4644; or, from within Virginia, Alaska and Hawaii on (703) 522-4770.

HISTORY OF CREDIT UNION TAXATION

OVERVIEW

The taxation of individuals and entities is as old as history itself. If one accepts the premise that governments need to carry out certain programs for the benefit of the people, then revenue to obtain those goals must be raised. Doing this fairly and efficiently is a never-ending process involving lawmakers and administrators at every level of government.

Since the 1860s, the tax laws at the federal level have almost uniformly recognized that cooperatives and other non-profit institutions should be treated differently from profit-making entities. The law makes this distinction by taxing the distributions of non-profits primarily at the membership level--de facto recognition that the institutions are merely extensions of their members.

This distinction has been ever-apparent in the case of credit unions since they are the only federally regulated financial institutions explicitly prohibited from dealing with the general public. The members of a credit union have a common bond based on occupation, association or geographic relationship. This true-mutuality concept is fundamental to the credit union movement. It means that only members can save and only members can borrow or otherwise be served.

THE EARLY YEARS

At the federal level, the initial leanings toward tax exemption for mutuals and membership organizations began with the Revenue Act of 1864. The Act set apart for tax purposes membership organizations that did no business with the public. The Revenue Act of 1894 expanded exempt institutions to include savings institutions or societies composed of members not participating in the profits of the organizations.

Although credit unions were not specifically exempt from the federal income tax, a 1917 United States Attorney General's opinion involving the federal tax liability of state-chartered credit unions in Massachusetts exempted that state's credit unions from federal income taxes. The basis for that exemption was the palpable similarities between credit unions and cooperatives.

COOPERATIVES EXEMPTED

The Revenue Act of 1916 granted for the first time a specific federal tax exemption for cooperatives. The Act also somewhat clouded the tax status of other non-profit institutions, such as state-chartered credit unions, by providing that the tax status of an organization was to be based on factors separate and distinct from its organizational makeup. Thus, state-chartered credit unions, while considering themselves tax-exempt cooperatives, began to seek specific statutory exemptions. The 1917

Attorney General's opinion was, however, the basis for exemption of state-chartered credit unions until the Revenue Act of 1951 formally conferred exempt status.

CURRENT TAX STATUS OF FEDERAL CREDIT UNIONS

The Federal Credit Union Act of 1934, as originally passed by the Senate, exempted Federal credit unions from all federal taxation, except taxes computed on real property and on tangible personal property. Language contained in the final version clouded the taxation issue--prompting the supervisory agency for Federal credit unions to request the Commissioner of Internal Revenue to review the issue. The agency noted the fact that regulations of the then Bureau of Internal Revenue exempted state-chartered credit unions from federal income taxes. In response, the Commissioner outlined a procedure for the exemption of Federal credit unions from federal income taxes. A clear-cut exemption was enacted in 1937 (Section 122 of the Federal Credit Union Act of 1934; 12 U.S.C. 1768) and remains in the law today. Section 501(c)(14) of Title 26 of the United States Code contains the exemption for Federal credit unions as a part of the Internal Revenue Code's list of exempt organizations.

THE TAXATION ISSUE IN 1985

OVERVIEW

The nation is now engaged in a concentrated debate on fiscal policy, involving a comprehensive reassessment of budget priorities and a re-examination of the federal tax code. In the course of that debate, it is entirely proper for the Congress and others to examine those provisions of the code that grant preferential tax status of one form or another.

The theory underlying this policy nexus is that the fierce competition for the nation's financial resources requires that those resources be allocated in the fairest, most efficient manner possible. Mushrooming budget deficits threaten the country's financial position in the world economy, and the perception of a tax system gone awry has diluted the efficiency of the system as more and more taxpayers search out ways, both lawful and unlawful, to evade its full reach.

NEW LOOK AT FINANCIAL ORGANIZATION TAX POLICY

One of the principal elements of the current focus is a re-examination of financial institution tax policy. In its historic November 1984 tax reform study titled "Tax Reform for Fairness, Simplicity, and Economic Growth," the Treasury Department argued strongly for changes in the tax treatment of all financial institutions. Besides revoking special tax provisions affecting banks and thrifts generally, the Treasury proposed repeal of the credit union tax exemption on the grounds that "[t]his tax break for [credit union] members gives credit unions a competitive advantage in attracting deposits from other financial institutions."

The broader rationale in the Treasury proposal (and the President's follow-up version), as well as in most other tax proposals now in the Congress, is that no sector of the economy should enjoy a competitive or economic advantage over another. This concept has come to be known as the "level playing field" philosophy.

THE FAIRNESS ISSUE EXAMINED

The concept of treating like institutions alike for purposes of achieving fair and equitable taxation cannot be faulted for its logic. However, as credit unions have consistently argued from the time of the first proposal in the Carter Administration, credit unions are not like banks and other thrifts. Therefore one must look beyond the "level playing field" for a rationale for taxation of credit unions.

On close examination of the issue, credit unions have perceived that the fundamental reason behind removing credit unions' tax exemption is to achieve equal "sacrifice" among all classes of taxpayers. The credit union community rejects this rationale.

- First, there is nothing fair about tax reform in any guise unless it is applied, unfailingly, across the board. Clearly, this is not the case--since virtually all of the tax-reform measures leave one or more of present tax preferences in place.

- Second, the President's tax-reform proposal, which is likely to be the model for bill-drafting efforts in the Congress, fails the test for consistency in advocating the taxation of credit unions with assets of $5 million or more. All credit unions, regardless of size, have the same characteristics of true mutuality, member service and volunteerism. Thus, there is no "tax" rationale for taxing only certain asset-size credit unions. The President's approach would not only be poor economic policy, but it is potentially divisive of the credit union movement.

EFFECTS OF TAXATION

Credit unions have historically supported sound economic goals. But credit unions must also grow with the times in order to pay competitive rates of interest and to meet the needs of their members. Credit unions have only one way to do this: by creating sufficient return on members' shares purchases (deposits) in order to establish sufficient reserves. Credit unions, unlike other financial organizations, have no stockholders; therefore, their reserves serve several needs.

- They are the source of funds for assuring that the credit union meets the statutory requirements for safety and soundness. That is, sufficient sums must be set aside, by law, to cover any losses on loans and/or investments.

- They allow the credit union to keep pace with modern-day financial practices. For example, members expect the credit union to generate their statements of account on loans and savings promptly and accurately. The credit union must provide for sufficient automation to handle these tasks and to interface with other financial institutions and with the Federal Reserve System.

- They provide the margin for growth capital. This is not to say that credit unions are seeking to outpace other financial institutions. To the contrary, credit unions' growth has stemmed by and large not from any entrepreneurial zeal, but from benign factors having to do with demographics, with corporate decisions to consolidate operations (requiring the credit union to serve more members in a single location), and with government policy changes. For example, in recent years the Treasury Department and the Department of Defense have substantially deregulated the procedures for the establishment of overseas military banking facilities to serve military personnel in those locations. The result has been that more and more of the larger financial institutions have chosen, primarily for financial reasons, not to participate in the military banking facility program. Credit unions have helped to fill that void because they have traditionally offered low-cost financial services to individuals of average means. They can do this because many of the planning and operations tasks in credit unions are done by volunteers.

The President's proposal, because it bases the tax/no-tax equation on asset size, would have particularly dire implications on the reserve position of credit unions both above and below the proposed $5 million-asset dividing line. Consider the following:

* Credit unions below the line would have a strong incentive to remain there for purely fiscal reasons. This stems from a fatal flaw in the President's proposal that would subject credit unions to taxation across the board once the $5 million-asset level was breached. Few things are certain in the realm of finances, but one clear truism is that no organization can remain static and yet remain viable. Small credit unions would be caught in this unconscionable lose-lose situation.

* Credit unions above the line would face an equally perplexing situation. Suppose, for example, that as a tax-planning strategy, a moderate-size credit union chose to take a number of steps to reduce its taxable income to a minimum. This plan could take several tacks: (1) operating expenses could be increased imprudently, resulting in inefficiency and in the accumulation of non-productive assets; (2) share dividend payouts could be increased, and (3) payments to reserves over the statutory requirements could be drastically reduced or eliminated. Any of these moves could have severe consequences for future capitalization. In extreme terms, credit unions might actively seek reductions in statutory reserve requirements so as to enable them to reduce their taxable income.

* Credit unions could pursue risk-laden investments in order to generate sufficient additional income to replace funds lost through taxation.

At all events, it cannot be denied that credit unions would be fundamentally weakened under any of these possible scenarios. Under-capitalization of a financial institution, regardless of its roots, can bode only problems for its future. Credit unions view taxation as a frontal assault on their safety and soundness. Over time, the erosion of their reserve base from taxes and the effects of tax administration could reduce their equity to a level less than half the recommended level for commercial banks. With over 400 savings and loans and over 900 commercial banks characterized as "troubled" (under-capitalized) by their regulatory agencies today, there is little wonder that credit unions look to their future under taxation with apprehension and concern.

Particulary nettlesome to the credit union community is the fact that the Administration is willing to risk the future financial health of credit unions for questionable fiscal gains. In fact, the budgetary consequences of credit union taxation are scarcely a blip on the federal ledger. For example, using calculations based on financial data in the President's proposal, federal revenues would grow in FY 1986 by slightly less than $80 million by taxing Federal credit unions--even assuming that all income were taxed at the highest rate (33 percent). Given the effects of even limited tax planning by credit unions and the application of graduated corporate tax rates in the President's proposal, the revenue gain would likely be less than two-thirds of this amount. Credit unions will work tirelessly to convince the Administration and other proponents of taxing credit unions that the risk is clearly not worth the return.

In the final analysis, the President's proposal, by creating a double standard for taxing credit unions, would violate the very concept of fairness on which tax reform is based. As President Reagan said in announcing his tax proposal to the nation, "The power to tax is the power to destroy." The credit union community poses the obvious question: Where is the common good in a taxation philosophy that could destroy the soundness of self-help, member-owned financial institutions that benefit over 50 million individuals?

SUPPORTING VIEWS

THE BILLS IN BRIEF

The majority of the tax reform/simplification proposals in the Congress would repeal the credit union tax exemption; one bill retains the current tax treatment of credit unions. The major proposals are:

"The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity." The President's proposal would tax credit unions with assets of $5 million or more. Tax rates would be set at 15, 18, 25, and 33 percent, depending on taxable earnings. Most exclusions and deductions would be eliminated.

"Fair" tax plan, S. 409/H.R. 800. Introduced by Senator Bill Bradley (D-NJ) and Congressman Dick Gephardt (D-MO). Would repeal the credit union tax exemption. Corporations would be taxed at a 30 percent rate.

"Flat" tax bill, S. 321. Introduced by Senator Dennis DeConcini (D-AZ). Would repeal the credit union tax exemption, eliminate most other exclusions and deductions and would tax all income at a 19 percent rate.

"FAST" (for Fair and Simple Tax) plan, S. 1006/H.R. 2222. Introduced by Senator Bob Kasten (R-WI) and Congressman Jack Kemp (R-NY). Would retain the credit union tax exemption.

SUPPORT FOR CREDIT UNIONS' POSITION ON TAXATION

The course chosen by Senator Kasten and Congressman Kemp, two of the most experienced advocates of tax reform on Capitol Hill, was not a drafting oversight. The staffs of the Senator and the Congressman examined the issue in the light of taxation of other financial institutions and concluded that the exemption for credit unions remains desirable and defensible. Here is the thinking of Senator Kasten as expressed in a February 21, 1985, letter:

> "As you well know, as member-owned cooperatives the earnings of credit unions have traditionally been taxed when distributed to individuals in the form of dividends. I believe that this is as it should be, and I will resist any and all efforts to alter the current tax treatment of credit unions."

Congressman Kemp outlined his views on credit union taxation in a March 26, 1985, letter to a concerned credit union:

> "Credit unions are unique financial institutions and this should be recognized in the tax code. Because they are non-profit and [are] run by their members, I firmly believe credit unions should retain their current tax status."

Another influential member of the Senate, Jake Garn (R-UT), Chairman of the Senate Banking Committee, addressed the question of credit union taxation during the last session of the Congress when the 1 percent capitalization of the National Credit Union Share Insurance Fund was discussed. The capitalization increase contributed almost $800 million toward reduction of the FY 1985 budget deficit. Recognizing these financial effects, the Chairman, in a February 27, 1984, letter to the Chairman of the Finance Committee, said:

> "Because credit unions, as self-help, member-owned organizations, are being asked to contribute $1 billion in capital to the government for the continued soundness of their institutions, I do not believe it wise or beneficial for credit unions or the government to consider taxing credit unions at the same time. Thus, I again urge that the Finance Committee not consider the taxation of credit unions."

The future course of credit unions was a major point of discussion at a recent gathering of credit union officials. Speaking to these officials at a March 5, 1985, session, Rep. Doug Barnard (D-GA), a member of the House Banking Committee, and chairman of a House subcommittee that has jurisdiction over both the National Credit Union Administration and the Internal Revenue Service, gave his reasons against taxing credit unions:

> "I can [make] a lot of valid arguments against [plans to tax credit unions]. You can start from the fact that credit unions are not open to the general public and, thus, are not like the other...businesses. [Further], the...recapitalization of the [National Credit Union] share insurance fund...meant that 8 percent of the revenue gathered by the federal government under the [Deficit Reduction Act's] authority came from credit unions. That is enough, for the present, to justify no taxation."

Rep. Tom Manton (D-NY), a new member of the House Banking Committee, in response to a question on credit union taxation at a March 11, 1985, credit union program, noted that:

> "In fact...you are not and should not be treated the same as commercial financial institutions, so I would be opposed to any thought of taxing you."

CREDIT UNIONS ARE NOT ALONE

In efforts to keep the present tax-exempt status, credit unions can be assured of solid support from the above Members of Congress and others of similar influence. These core supporters of the credit union position on taxation have taken the time to examine the impact of the current proposals to tax credit unions, and they have concluded that taxation would place these small member-owned financial organizations in jeopardy.

TAXATION: THE VIEW FROM WITHIN

CREDIT UNIONS ARE DIFFERENT

From a financial perspective, the objectives of the credit union community are little different from those of other segments of the economy: sustained, non-inflationary growth in the economy; stable financial-institution policy that reduces unnecessary government presence in the marketplace; enlightened regulations that protect consumers but avoid costly duplications of federal/state oversight; and systematic budget reforms that rule out ineffective programs and policies. Credit unions have a rich tradition of helping their members attain economic goals, but credit unions are not banks and they are not savings and loans. Their evolution and their mission differ from these other types of financial institutions.

BACKGROUND

The Federal Credit Union Act defines a credit union as a "cooperative association organized in accordance with the provisions of [the Act] for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes" (12 U.S.C. 1752(1)). Therefore, according to law, the defined elements of a credit union are: (1) it is a cooperative association, (2) it is organized in accordance with the enabling statute, and (3) its principal purposes are to promote thrift among its members and to create a source of credit for worthwhile purposes. In carrying out this mandate, credit unions provide many services to meet the demands of today's economy.

Unlike most other financial institutions, credit unions perform these services as true cooperative organizations--in philosophy, organization, and operation. Credit unions have historically been in the forefront of regulatory changes benefiting consumers; they have a consistent record of paying maximum dividends to their members; and they have a tradition of maintaining close communication with their members. Much of this is because, in a credit union, the members manage the operations through the democratic process. Each member has one vote, regardless of the number of dollars held or the amount of loans owed.

CREDIT UNION OPERATIONS

Credit unions are non-profit organizations. Although a credit union often realizes net earnings over the cost of its operations, these earnings are not the purpose for which a credit union is formed. They are the result of the cooperative efforts of many unpaid volunteers. Earnings not paid out in dividends or used to provide services are kept in the credit union to maintain financial stability. These retained earnings may also be used to meet unexpected financial needs of the members. For example, many credit unions serve employees of manufacturing companies. The entire membership of such a credit union could face the possibility of layoffs or other acute

financial difficulties during periods of economic instability. Under these circumstances the credit union is relied upon to provide lifeline financial services. Many credit unions will establish special loan plans at reduced interest rates to help their members. In addition, many credit unions provide lifeline services, such as no-charge checking accounts and free financial counseling.

Credit unions, regardless of size, continue to embrace the fundamental service principles of the movement; they fill financial-service voids in specific geographic areas at the urgings of employers and others who seek low-cost financial services for members of a well-defined group. Credit unions respond to these needs without fixing their sights solely on the balance sheet potential of their decisions.

Thus, an accumulation of retained earnings in the credit union in the form of reserves does not indicate a profit-making purpose over the long term. Without some retained earnings, credit unions may not continue to meet the needs of their members.

CREDIT UNIONS PAY THEIR OWN WAY

Credit unions have helped to achieve a significant reduction in the FY 1985 deficit. On January 21, 1985, all credit unions with federal insurance deposited with the National Credit Union Share Insurance Fund in the Treasury an amount equal to 1 percent of their insured shares (12 U.S.C. 1782).

This action was taken under the Deficit Reduction Act of 1984, and has as its long-term purpose the build-up of the fund's reserves; but its short-term effect was to reduce the FY 1985 budget deficit by almost $800 million. These funds are a significant part of the additional sums raised by this Act to combat the deficit. In fact, figures from President Reagan's 1986 budget indicate that credit unions contributed about 8 percent of the additional revenue expected to be collected in FY 1985 under the authority of the Deficit Reduction Act. Credit unions did not wait to be led into this action on the deficit; they actively sought enactment of legislation in the Congress.

Apart from this significant contribution, credit unions also pay the full administrative costs of their federal regulatory agency, the National Credit Union Administration. Fees levied on credit unions cover the entire cost of NCUA's expenses for chartering, supervising and examining credit unions, and for administrative overhead. With today's federal budget expenditures approaching $1 trillion, credit union members can be proud that the taxpayers are not charged for NCUA's operations--the cost of which will be almost $20 million in FY 1985.

Furthermore, Federal credit unions must place non-interest-bearing reserves with the Federal Reserve System when certain deposits and/or account balances exceed a minimum level. Credit unions do not receive interest on these reserves, even though the Federal Reserve has the use of the sums for

investment purposes. In effect, these sterile reserves are a hidden tax--siphoning funds (interest on the required balances) that could be passed on to credit union members. Unless legislation is enacted requiring the payment of interest to credit unions on these balances, members' contributions are increasing the Federal Reserve's investment earnings. In FY 1984, over $15.5 billion of these earnings were paid into the Treasury's general fund.

Other little known aspects of credit unions' interactions with the federal government demonstrate their independence and self-help characteristics:

- They serve as fiscal agents of the government under the Federal Credit Union Act--cashing government checks for members and, when so designated, serving as depositories for the public funds handled by United States collecting officers (12 U.S.C. 1767).

- The National Credit Union Share Insurance Fund was established in 1970 with no federal subsidy, a radical departure from earlier procedures when seed capital was provided from the Treasury for both the FDIC and FSLIC insurance funds.

VOLUNTEERS PLAY AN ESSENTIAL PART

All financial organizations have boards of directors that establish the operating policies for their institutions. With few exceptions, the members of these boards are compensated for their services. Here again, credit unions are subject to different ground rules. Their boards of directors, except for a single member, serve without compensation and, indeed, may not be compensated under the law (12 U.S.C. 1761).

Moreover, because of their small size in relation to other financial intermediaries, a large part of their operations is carried out by volunteers. As a matter of fact, many are dependent upon volunteers for their entire staff.

This volunteerism has been a strong impetus for the community spirit of the credit union movement. Proponents of tax reform might say that the taxing of credit union earnings would have no impact on this significant aspect of the movement. But, there is always the danger that:

- Taxation would create independent pressures to change the way credit unions function. For example, credit unions would have to become familiar with nuances of the tax code.

- Services provided by the members of the boards of directors, as well as other volunteer services reaching into virtually every facet of credit union operations, might be viewed as services that could be expensed for tax purposes. These volunteer services are conservatively estimated to be worth $200 million annually in 1985.

If the volunteer character of credit unions is eroded through these economic pressures, then the central elements of credit union philosophy--the common bond among members, maximum service at the lowest cost, and member counseling and education--would be in jeopardy.

SAFETY AND SOUNDNESS

Another major concern of the credit union movement over taxation is the effect on safety and soundness--two fundamental elements of the credit union philosophy. Unlike stock-issuing financial institutions--such as banks and savings and loans--the ownership of credit unions is reflected in members' holdings of shares in the credit union. Therefore, there is no source of capital other than retained earnings to provide for contingencies and for expansion. While the effects of taxation on credit unions would differ under each of the bills now before the Congress, a study done within the credit union community projects that the effect of taxation on credit unions' retained earnings would be severe over a period of several years.

This troublesome possibility prompted the former Chairman of the Board of the National Credit Union Administration (NCUA) to write to the Chairman of the Senate Finance Committee in February of last year during the Committee's deliberations on proposed legislation to reduce the deficit. The NCUA Board Chairman stated that, in his judgment, the taxation of credit unions could seriously affect their financial soundness. Credit unions feel strongly that these cautionary words should be closely considered anew by the Congress as it fully enters the debate on tax reform.

MYTH OF CREDIT UNIONS AS EQUALS

In recent years, credit unions have been authorized by the Congress to offer their members additional services, including the authority to make first-and second-mortgage loans on homes and the authority to offer automated teller services and share draft accounts. Even with these expanded powers, credit unions have restrictions on the services they can offer. For example:

* Credit unions may make loans only for members' purchases of consumer items, such as automobiles; and for homes, home improvements and education expenses. Mortgage loans are limited to principal residences and may not be made for vacation homes or for investment property.

* Credit unions, unlike other financial institutions, are barred from making commercial loans.

The fact is that, even where credit unions have been granted authority paralleling those available to other financial institutions, they were authorized to do so only because their members had financial needs that other institutions were not fulfilling at reasonable and affordable costs. Credit unions were formed to meet those needs even though their limited fields of membership prevent the vast majority from competing for customers on a one-on-one basis with other, larger financial organizations.

SUMMATION

From a reasoned perspective, the justification for removing the credit union tax exemption cannot be based on the issue of equity. In truth, credit unions do not enjoy equal status with other financial organizations; indeed, they were not designed to operate on the same plane.

Each of the classes of financial institutions performs a specific function to meet particular credit needs within the financial marketplace. Although some of the activities overlap, the primary missions differ:

* Credit unions are designed to promote thrift and to provide credit to individuals within a fairly narrow and well-defined field of membership.

* Credit unions are financial cooperatives whose role is to give the small saver maximum return on his or her investment, and to offer consumer loans at the lowest feasible rates.

* Credit unions are an important part of community and employment life; they depend heavily on volunteers; they have limited authorities that are spelled out in law; and they are non-profit cooperatives.

The credit union community has, in the past, done its part in helping to achieve the economic goals of our country. Credit unions can be counted on to continue down that path--not only because they have a responsibility to the nation as a whole but because, in the final analysis, programs and policies that have a truly positive impact on America's capacity to produce goods and services efficiently and fairly will improve the well-being of all Americans. In speaking out on taxation, credit unions ask only that those in the Congress and the Administration who are proposing to tax credit unions look at all the facts. After such a review, we are convinced that impartial lawmakers will conclude that such a change could reverse decades of progress in the evolution of our nation's financial-services structure.

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REPEAL TAX EXEMPTION FOR LARGE CREDIT UNIONS

General Explanation

Chapter 10.03

Current Law

Credit unions are exempt from tax on their income, whether such income is retained or distributed to depositors.

Reasons for Change

Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. The tax-exempt status of credit unions has enabled them to grow rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Since 1962, credit unions have enjoyed a 13 percent annual growth rate in financial assets, compared with an 11.1 percent rate for savings and loan associations, 9.4 percent for commercial banks, and 7 percent for mutual savings banks. Due to expanded powers and faster growth, credit unions accounted for 10.8 percent of total consumer credit (not including mortgages) in 1983 compared with 6.6 percent in 1962.

In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions thus should generally be subject to tax on the same basis as other financial institutions.

These arguments apply with particular force to large credit unions, which are substantially equivalent to commercial banks and thrifts. Most credit unions, however, are relatively small. Over 80 percent of all credit unions have less than $5 million of gross assets. Revoking the tax-exempt status of small credit unions would impose a significant administrative burden for a relatively small revenue increase.

Proposal

The tax exemption for credit unions with assets of at least $5 million would be repealed. Such large credit unions would be subject to tax under the same rules that apply to other thrift institutions. Credit unions with assets less than $5 million would continue to be exempt from tax.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Tax exemption at the company level allows customer/owners in credit unions to defer tax liability on earnings retained by the credit union. By retaining their earnings tax-free, credit unions can offer their customer/owners higher rates of return than other financial institutions. Repealing the tax exemption of credit unions would eliminate the incentive for such credit unions to retain, rather than distribute, current earnings.

In 1983, Federal credit unions earned $4.0 billion in net income and distributed $3.6 billion in dividends or interest refunds to customer/owners. Retained earnings, which are tax-exempt and accrue tax-free interest income, were 10.6 percent of current net earnings. The proposal is limited to credit unions with assets of at least $5 million because, while approximately 82 percent of all credit unions (13,020 out of a total of 15,877 credit unions) in 1983 had assets less than $5 million, the credit unions above this threshold accounted for approximately 80 percent of retained earnings for all credit unions.

The proposal would subject large credit unions to tax on their retained earnings. To the extent that retained earnings are necessary for growth, large credit unions would have to increase the spread between their "dividend" rates and loan rates to cover the Federal tax liability in the same manner as stock companies. As with other mutual depository institutions, however, large credit unions could reduce the amount of Federal income tax paid at the corporate level by distributing more "dividends" to depositors or by providing lower loan rates to borrowers. Distributions of earnings would be included in taxable income currently at the individual level.

Appendix C

Six Examples of Credit Union Taxable Income Under The President's Proposal

Calendar Year Ending December 31, 1984

Asset Size (in millions)		25	38	64	210	16	11
Gross Income (in thousands)	(+)	$ 2,767	$ 4,093	$ 9,069	$ 24,583	$ 1,816	$ 1,165
Operating Expense	(-)	687	1,272	3,321	6,795	400	281
Provision for Loan Losses	(+)	-0-	46	142	248	-0-	24
Loan Protection Insurance	(+)	20	25	77	122	-0-	10
Dividend Interest Expense	(-)	1,767	2,311	4,649	15,309	1,174	682
Other Adjustments	(-)	21	131	150	300	20	15
Net Taxable Income		$ 312	$ 450	$ 1,168	$ 2,549	$ 222	$ 221
Estimated Federal Income Tax		103	148	385	841	72	72
*State Income Tax		21	31	81	178	15	15
Net Transfer to Reserves and Undivided Earnings		188	331	633	1,460	155	115
Percent Reserve Transfer Reduced		40%	35%	43%	41%	36%	43%

* The effective rate for state taxes was calculated at seven percent (7%) which is a fair average for the Washington, D.C. Metropolitan Area for Corporate Taxes.

NATIONAL CREDIT UNION ADMINISTRATION
Washington, D. C. 20456

February 24, 1984

Honorable Robert Dole
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The purposes of this letter are as follows: (1) to make you aware of a credit union initiative currently underway which would result in a deficit reduction of $850 million; (2) to inform you that in my judgment, your Committee's present initiative to impose a tax on credit unions runs directly counter to this credit union effort and could adversely affect its outcome; and (3) to alert you to serious safety and soundness problems associated with any proposal to tax credit unions. Let me explain.

The National Credit Union Administration, an independent agency, is charged with the supervision of our nation's Federal credit unions. One of our responsibilities is the management of a Share Insurance Fund which insures credit union accounts up to $100,000. This fund has simply failed to grow sufficiently over the past 13 years from the premiums which are charged to credit unions and it has remained at an uncomfortably low level. A proposal was developed to permit credit unions to vastly increase the size of this fund by placing a deposit of 1% of their insured shares in the Fund. This would result in an immediate contribution of $850 million which would count as a net increase in Federal revenues. This contribution would continue to grow as credit unions grow. They increased by almost 21% in 1983.

Chairman Garn of the Banking Committee introduced this legislation, S. 2121, on November 17, 1983 and we are presently working for introduction in the House Banking Committee. As you can imagine, such a plan needs the full support of the credit union movement. Such support appears to be crystallizing at this very moment. We have received over 2,000 letters from individual credit unions in favor of this proposal and a number requesting further information. However, there are still a large number of credit unions which are still deciding.

Needless to say, the Committee's proposal to impose a tax on credit unions at this time is naturally causing disruptions to the discussions taking place. Not only are negative emotions being aroused, but computations of two potential sets of cost figures will simply magnify the confusion and the misinformation. In short, it would appear to me that the Committee's efforts to raise perhaps $100 million per year in taxes could stall, if not prevent, the voluntary effort to contribute $850 million.

While I am, of course, always concerned with contributing in any way to deficit reduction, my primary interest in this matter is safety and soundness. In my judgment, the taxation of credit unions could seriously affect their financial soundness. In an effort to minimize any taxation, credit unions would concentrate on returning as much of their earnings as possible to their members in the form of dividends. However in doing so, many could inadvertently jeopardize their financial picture, including their reserve base, in the interest of giving the money to their members rather than to the Internal Revenue Service. While it is quite understandable, it is also potentially harmful. Therefore, I believe that we should have the opportunity to examine in detail any proposal to tax credit unions and to assess its impact on the operations of this agency.

Should you or your staff have any questions or desire further information, please contact me or my General Counsel, Mr. Wendell Sebastian, at 357-1100.

Sincerely,

E. F. Callahan

E. F. CALLAHAN
Chairman

cc: All Committee Members

The CHAIRMAN. I might just add, Mr. Hess, that we faced this a year or so ago and it should be once again pointed out for the record that when the Finance Committee was talking about $300 million worth of taxation, at the same time we were talking about the voluntary increases of nearly $1 billion which the credit union movement made. I pointed out to Senator Dole at the time that it wasn't a very good trade, $300 million of taxation to not have that $1 billion of increased funding put in, which also counted, as scored with Mr. Stockman, as a deficit reduction item. I don't think the administration has been willing to look at or possibly not even be aware of that situation. Those voluntary funds could be withdrawn so you could have a huge net loss of impact on the deficit.

Mr. Perkowski.

STATEMENT OF JOSEPH PERKOWSKI, MANAGER AND TREASURER, MINNEAPOLIS FEDERAL EMPLOYEES CREDIT UNION, MINNEAPOLIS, MN, CHAIRMAN, CREDIT UNION NATIONAL ASSOCIATION

Mr. PERKOWSKI. Mr. Chairman, before I begin, I'd like to thank you for your efforts last year in that regard and also for your support you gave us this year on the taxation issue and we also are very grateful to you for your help in assuring that our servicemen and servicewomen will continue to enjoy the benefits derived from being able to shop more for financial services.

[The complete prepared statement follows:]

STATEMENT OF

JOSEPH PERKOWSKI

ON BEHALF OF THE

CREDIT UNION NATIONAL ASSOCIATION, INC.

Mr. Chairman, members of the Committee, I am pleased to be here today as the newly elected Chairman of the Credit Union National Association, Inc. to participate in your review of the present financial system and the steps necessary for reform. For the record, the Credit Union National Association (CUNA) is an association of credit union leagues located in each state, the District of Columbia, and Puerto Rico. Through these leagues, CUNA represents approximately 18,500 federal and state chartered credit unions serving more than 50 million individual members.

It is my distinct pleasure to be able to sit here and inform you and the members of this Committee that the credit union movement in America is healthier and is providing more services to more people than at any time in its history. As you consider and debate the serious problems faced by other sectors of the financial community, I urge you to pause and reflect on the good news that credit unions have to share.

Further, as you consider making changes for banks and savings and loan associations--such changes as expanded powers, or interstate banking or inter-industry acquisitions, we want you to know that credit unions are asking nothing of Congress. Nevertheless, we welcome whatever decisions you make to improve the lot of the financial consumer, including those that could competitively test our ability to serve our members.

Last month you received testimony from our regulator, the National Credit Union Administration. NCUA testified in detail on the financial

condition of credit unions. The NCUA Annual Report further documents that there has been a substantial drop in the number of problem credit unions and a very healthy upsurge in consumer loan activity. Your bill of last year contained a few relatively minor credit union amendments which address certain internal credit union operations, and we would be pleased to see them introduced again this year. These amendments are:

(1) The power for individual credit unions to set loan rate ceilings;

(2) A clarification of credit union fidelity bond coverage;

(3) A modification in the selection of membership officers; and

(4) A clarification in the methods available for expelling a credit union member.

Also, NCUA has requested that their conservatorship authority be made permanent to provide substantial savings to the Share Insurance Fund. We certainly support any move to maintain the strength of the Fund.

Over the last two years, credit unions have, on their own initiative, taken two major steps to assure the soundness of the national credit union system. Credit unions fully funded the Central Liquidity Facility, our source of back-up liquidity, and bolstered their Share Insurance Fund with an infusion of $850 million. The combined total of these two actions reduced the Federal deficit by $1 billion. Needless to say, we are pleased with our accomplishments and our continued ability to solve our own problems instead of coming to the Congress for assistance.

In all honesty, Mr. Chairman, I wish that this concluded my statement. I wish I could simply give you this report, answer any questions and return to Minnesota reasonably confident that Congress and the Administration are pleased with the achievements of the credit union movement and are reassured that their long-standing commitment to credit unions has paid off -- not only to the 50 million credit union members of this non-profit system, but to taxpayers as well. Unfortunately, this is not so. This Congress is considering drastically changing the credit union movement as we know it today. As part of most tax reform plans, the tax exempt status of credit unions would be eliminated. CUNA recently completed a series of tax seminars around the country designed to measure the impact of such taxation on the credit union movement. It was the clear consensus of credit union managers and leaders that if enacted, taxation would (1) alter the quality and affordability of the services consumers derive from their credit union, and (2) jeopardize the safety and soundness of the entire movement.

In today's environment of concern over public confidence in our financial systems, I simply do not understand a plan to tax part of the reserve cushion of a healthy system. Perhaps the tax-writers were not aware that credit unions have no capital stock. Credit unions' only way of setting aside capital to meet unexpected events or emergencies is through retained earnings. Retained earnings and statutory reserves constitute the equity of the credit union movement. Our estimates regarding Treasury II show that

over the past five years taxation would have reduced the overall reserve cushion of credit unions by 20%. In other words, the equity level of the entire credit union movement would have dropped from its present $8.1 billion to $6.6 billion, or to 5.7%. The potential Federal government liability to guarantee the soundness of credit unions is dramatically affected. A further discussion of the implications of reversing credit union tax policy is contained in Enclosure 1 to my testimony. Enclosure II contains our recent statement before a House Banking subcommittee on the matter of credit union taxation. CUNA is also developing a detailed economic analysis of the latest Treasury plan which we will supply for the record. I am aware that over the years this exemption has been granted to others and subsequently reversed when they abandoned their original mission and substantively changed their internal structure. It is our contention that this has not occurred at all within credit unions and that the benefits we offer our members and the nation are greater than ever.

In my judgement, taxation of credit unions would be a social tragedy. Those of us in the credit union movement are obligated to bring this to your attention. To do so, we have alerted the country's 18,500 credit union managers, the 52 league presidents and their staffs, the 250,000 volunteer directors who serve in our credit unions, and, of course, our 50 million members. We also intend to work closely and in harmony with our fellow

trade association, the National Association of Federal Credit Unions (NAFCU) and their fine leadership and staff.

Mr. Chairman, I'm here today to make one request of the Senate Banking Committee. For 48 years Congress has maintained a special public policy, a pact if you will between itself and the credit union movement. In recognition of the non-profit structure and mutual ownership of credit unions and in return for social benefits far exceeding any lost tax revenues, the Congress has exempted credit unions from taxation. These conditions still exist today. Credit unions, big and small, are still operated on a not-for-profit basis; they are still managed by volunteer boards of directors and committees; and they still remain consumer-driven organizations. Because credit unions are still fulfilling the mission Congress envisioned 48 years ago when lawmakers declared them tax-exempt, we don't understand why you are considering reversing yourselves.

My request is this: that before Congress makes any move to walk away from its commitment to credit union members, a full hearing be held by this, the Committee with specific jurisdiction over credit unions. Quite frankly, Mr. Chairman, we find it disheartening and frustrating that this issue so crucial to our future has been relegated to relative obscurity in a giant tax bill. I have inserted on the next page of my testimony the actual text of the tax policy under discussion with respect to federal credit unions.

FEDERAL CREDIT UNIONS

Chapter 14 of Title 12 of the United States Code, as amended to January 12, 1983

§ 1751

Short Title.—This chapter may be cited as the "Federal Credit Union Act" (June 26, 1934, § 1, 48 Stat. 1216; Sept. 22, 1959, § 1, 73 Stat. 628).

Act of June 26, 1934, cited to the text was entitled "An Act to establish a Federal Credit Union System, to establish a further market for securities of the United States and to make more available to people of small means credit for provident purposes through a national system of cooperative credit, thereby helping to stabilize the credit structure of the United States."

Title I—General Provisions

§ 1768 § 122

Taxation.—The Federal credit unions organized hereunder, their property, their franchises, capital, reserves, surpluses, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of such Federal credit unions shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. Nothing herein contained shall prevent holdings in any Federal credit union organized hereunder from being included in the valuation of the personal property of the owners or holders thereof in assessing taxes imposed by authority of the State or political subdivision thereof in which the Federal credit union is located; but the duty or burden of collecting or enforcing the payment of such a tax shall not be imposed upon any such Federal credit union and the tax shall not exceed the rate of taxes imposed upon holdings in domestic credit unions. (June 26, 1934, § 18, 48 Stat. 1222; Dec. 6, 1937, § 4, 51 Stat. 4; Sept. 22, 1959, § 23, 73 Stat. 637; Oct. 14, 1970, Pub.L. 91–468, 84 Stat. 1015.)

As you can see, the credit union tax exemption is not a loophole carved out in the tax code for the benefit of an already existing special interest group. On the contrary, this was a policy decision by Congress to prevent the then existing oppressive taxation by the states from disrupting the possible success of the credit union idea. In concert with this action, a similar exemption was established for state credit unions under Section 501(c)(14) of the IRS code.

Credit unions (and their tax exemption) came into being at a time when many financial consumers were having difficulty obtaining financial services at other institutions. The Congress was concerned with the charging of high loan rates, other excessive charges, and the discouraging of small low balance accounts. Today the Congress is considering legislation to require other institutions to treat their customers as credit unions do. There are bills on funds availability, lifeline services, family banks, disclosure, truth in savings, and others. It seems totally incongruous to us to legislate credit union-like behavior for others and to legislate for credit unions a direct incentive to adopt a "profit-driven" operational philosophy.

Mr. Chairman, this spectre of taxation is raised year after year. It sends a confusing and disheartening message to many who are committed to the success of the credit union movement. It's time to stop and review the policy so that all parties know that it is valid and current, what the terms are, and that it will remain so as long as its conditions are met.

Invite our detractors. Call in the drafters of the credit union provisions in the Treasury bill. Contact your constituents. But please, do us a favor. Give us our day in court. As it stands now, we are at a complete loss to explain to our members why Congress is considering reversing itself. They cannot make sense of the reasons given for taxing credit unions. The Administration contends that credit unions have grown more rapidly than banks and savings and loans over the past 20 years. Why does the President consider credit unions' rapid growth a problem? A problem for whom? Banks and S&Ls? Consumers? Taxpayers? We don't understand why the advantages consumers enjoy from credit unions should be removed in the interest of fairness to banks.

Moreover, the Administration wants to keep some exemptions in the tax code. These include the home mortgage deduction, special treatment of Social Security and veterans' disability benefits, and itemized charitable deductions. The Administration justifies retaining these tax preferences on the grounds that "they are widely used and generally judged to be central to American values." Credit unions clearly fall into this general catagory. Their exemption is 'widely used' by 50 million people to further habits of thrift, prudent borrowing and volunteer service. What could be more American? What could be more beneficial to the American family?

In short, we in the credit union movement are confident that if the full story behind this sector of the financial system were presented to Congress,

it would reaffirm our preferred tax status. In every state and city and town, there are examples of credit unions earning their tax exemption every day.

As you are aware, Sen. Garn, in your own state of Utah, a major employer, Kennecott Copper, is in the process of a shutdown that is affecting thousands of workers. At the Cyprus Credit Union in Magna, many members are Kennecott employees. Over the past few years, during extended layoffs, the $54 million credit union has helped over 2,500 of these people by extending their loans, reducing their monthly loan payments and allowing many to let two or three months pass without making any payments. This flexibility on the part of the credit union helps these workers over a difficult period while they try to find other employment.

Another example is in Senator Heinz's state. There the $70 million Philadelphia Federal Credit Union was among the first financial institutions in the country to install special braille-equipped automated teller machines for the visually handicapped.

Or in Senator Dixon's state of Illinois where the Diesel Credit Union in Countryside took on the responsibility of serving a rehabilitation center for physically and mentally retarded adults. The credit union takes special pains to serve those members; it gives them counseling about the simplest financial transactions and even employs some to perform routine jobs at the credit union.

I remember in my own credit union when the air traffic controllers' union was in crisis. We had nearly 300 controllers with outstanding loans totalling $1.5 million. They were specially trained people and out of work. They literally had to start all over. We worked with each one and carried them as long as they worked with us. I'm pleased to say that most of them made it.

I will be supplying the Committee with other such examples of credit union service (Enclosure III). There come from all of the states represented by the members of this Committee, and they comprise truly a good news story.

Finally, Mr. Chairman, the Committee should be aware of the financial reform implications of taxation. Taxation will force a shift in credit union management philosophy from service (or member) driven to profit (or tax avoidance) driven. Once this occurs, it will be entirely appropriate to expect a series of requests for credit union legislative changes. A preliminary assessment leads me to suggest some of the following: some method of raising capital stock; the ability to convert to stock ownership; the ability to pay all board members; a method to eliminate free and unprofitable services or accounts (this would probably best be accomplished by having different classes of membership and/or by eliminating the membership concept and simply establishing a traditional business relationship with the general public); and certain new investment authorities to permit the chance for higher yields on investments. Finally, I am sure we will want to rethink the

capitalization of the National Credit Union Share Insurance Fund if the premiums became tax-deductible. As you can see, the real cost of taxation will not be measured just in dollars.

I thank you for the opportunity to present my views on the biggest crisis to ever face the credit union movement. I'll be glad to answer any questions.

EXECUTIVE SUMMARY June 18, 1985

CREDIT UNION TAXATION

Reversing established public policy toward the credit union movement--a costly proposal.

Credit unions have the healthiest financial system in America today. In large part, this is attributable to existing Congressional policy which has fostered this "not for profit" system. In today's environment of ever mounting Federal liability associated with the banking and savings and loan systems, the vitality of credit unions remains unique.

As part of a tax-reform and deficit reducing effort, Congress is being asked to consider reversing its policy. Estimates of anticipated income from taxing credit unions range from $200-400 million per year. For this relatively modest income, the credit union tax exempt policy would be removed. The social and economic risks of an undoing of this system are difficult to calculate. But the healthiest sector of today's savings system will certainly be threatened.

This document reviews the bases for the original Congressional policy. It also sets forth the social benefits which have been realized and the disruptive impact of reversing present Federal policy. It explains how:

- The tax exempt policy encourages a system of cooperative credit as an alternative to the traditional "for profit" banking system. This $100+ billion system is dedicated by law to the formation of capital and to providing consumer credit.
- Unlike the banking and savings and loan sectors, there are no major potential Federal liabilities within the credit union system.* One result of Federal policy (tax exemption), has been the complete willingness of credit union decision-makers to manage their own emergencies and problems.
- In 1984-85, credit unions used their resources to fully capitalize their central bank and insurance fund in the amount of $1 billion. This reduced the Federal deficit by a billion dollars.
- Reversing the tax-policy would dangerously reduce the capital of the entire movement. Confidence in the system will be much more vulnerable.
- Reversing the tax policy would open the door to taxation by individual states and the attendant burdens.
- Eventually, if not suddenly, the willingness (and even the ability) of the system to manage its own emergencies could completely disappear.
- A guaranteed and growing source of low cost consumer credit would disappear.

* * * * * * * * * * *

*See 1984 Annual Report of the National Credit Union Administration.

Enclosure I

51-337 O—85——13

CREDIT UNION TAXATION

Reversing established public policy toward the credit union movement--a costly proposal.

Historical Perspective

The 99th Congress is likely to be asked to reverse a 48-year old public policy decision concerning the credit union movement in this country. This decision, to exempt the income of credit unions from taxation, was deliberated and affirmed in 1937. This was three years after enactment of the Federal Credit Union Act in 1934. The original act permitted states to tax credit unions on the same basis as banks. This was generally done on the basis of share capital. Since by law credit unions cannot accept deposits, all shares were vulnerable to taxation. The tax burden became so oppressive that the Congress established the policy of tax exemption in 1937.

The change was adopted by the Congress to encourage the success of the credit union movement whose goal was to bring financial services to those who were at a disadvantage in obtaining them elsewhere (hourly wage earners, military, elderly, students, etc.) and to develop a credit union system as an alternative to the traditional "for profit" banking system. In 1951, this policy was reviewed by the Congress and reaffirmed. Because of this policy, there now exists a reliable and sizeable source of low cost consumer credit (presently over $100 billion). This system is dedicated by law to the accumulation of savings and the extension of consumer credit.

Bases for Exemption

The tax exempt policy was based on the fact that credit unions are organized and operated on a non-profit basis. They have no capital stock, they are mutually controlled, they are directed by volunteers, and most have close relationships with sponsoring companies. These conditions remain true today.

Forces for Taxation

Ironically, but not unexpectedly, it is the very success of the movement itself which is provoking the forces for taxation. On the one hand, banks and other "for profit" financial institutions are recognizing that cooperatives can deliver very attractive financial services to the American consumer. They seek to restrain the success of the movement on the grounds of "fairness." Also, the aggregate size of the movement (now $100 billion and growing 15-20% per year) has become a potential source of tax revenue for those addressing budgetary problems.

To justify the imposition of a tax on the credit union movement, certain arguments are generally raised. These are really excuses as they are not related to the bases for exemption (accomplishing social goals, non-profit, volunteer, mutual, etc.). However, because these arguments are so persistently raised, they must be addressed as follows:

ARGUMENTS

1. "Credit unions have an unfair advantage. They should be forced to play on a level playing field."
   Response: First of all, any real advantage for credit union members comes from the non-profit structure, the volunteers, the close sponsor relationships, and the mutual ownership. Second, a healthy financial system is hardly an unfair advantage and certainly not one to consider removing. Third, the total assets of all credit unions are less than those of the Bank of America. Credit unions both individually and collectively are very small compared to banks and thrifts. Finally, credit unions limit themselves to providing consumer financial services to specific pre-existing groups.

2. "Credit unions have grown much larger than the small institutions they once were."
   Response: 95% of all credit unions are under $20 million in size; 50% are under $1 million. There are only five which are over $500 million and two which are over $1 billion. Credit union size varies directly with membership. The largest (Navy FCU) has the most assets ($1.5 billion) because it serves the most members (674,000).

   There is no real difference between the smallest and the largest credit union, but credit unions are very different from banks. For example, the largest credit union (NAVY) is open 24 hours a day, 365 days a year to serve its members worldwide (50 loans are made on a typical Christmas day); it has 135,000 accounts less than $10 and an additional 182,000 less than $100; there are no minimum balance requirements and there are no fees for a wide range of basic financial services available to all members; finally, since the majority of its members are enlisted, it concentrates on accumulating savings and thereby making credit available on reasonable terms, to persons who otherwise could not get it. The loan to total savings ratio for the past 10 years has been 93%.

3. "Credit unions have powers and offer services that they didn't have when the original tax-exemption was granted."
   Response: These limited newer powers were granted by the Congress and were not given as a pre-condition to changing the tax status. In general, the powers modernize the delivery of services

to credit union members. Further, credit unions are not seeking additional powers and want to remain in the consumer area.

4. "Won't it be fair if we grant tax exempt status to the vast majority of smaller credit unions?"
Response: Absolutely not. In the long run this will not serve to benefit even the smaller credit unions because almost all of the equity of the credit union movement would still be taxed. The devastation to the overall system as outlined in this paper would still occur. Because of the nature of the credit union system, the well-being of individual credit unions is closely tied to the well-being of the overall system. Ironically, this approach could be particularly painful for the smaller credit unions as the management decisions and attendant support of the rest of the system adjust away from them toward the "profit-driven" scenario. Even the smallest credit union is vitally concerned that the policy toward the entire credit union system not be changed. A law so dividing the credit union movement cannot be viewed as a form of assistance.

Further, history has shown that once an overall policy is reversed, the exceptions within it become more and more difficult to maintain or to justify. Either the tax arm will reach further down or membership growth will bring the additional credit unions into the fold of taxation.

Member-Driven Financial System

Because of the continuous support and encouragement of the Congress, the credit union movement has succeeded in reaching the lives of millions of Americans. This cooperative form of financial services delivery is not profit-driven but rather is fueled by the goal of being of service to members. A necessary ingredient in its success is the continued awareness by government decision-makers of the unique difference between "profit-driven" and "member-driven." Taxation, in addition to its onerous financial and paperwork burdens, would send a clear signal that the Federal government no longer sees nor encourages this alternative for American consumers. It is ironic that this would occur at a time when the Congress is considering a requirement for banks to provide lifeline and other consumer services.

The social and economic costs of reversing this fundamental policy towards the credit union movement will far exceed the very limited revenue.

Benefits from Existing Policy

The following social/economic benefits have been realized by a policy which has encouraged the formation of a credit union system:

- The credit union financial system is in excellent financial condition.* Because of its willingness to manage its own problems, there exist no major potential Federal liabilities. This is not true of other systems.

- Through mutual self-help, there is now in place a separate system to meet the liquidity, regulatory, information, and insurance needs of all credit union members.

- Close personal service is given to all members regardless of their income or size of accounts. This includes financial counseling and the promotion of good credit and savings habits. Basic lifeline services are always available to members of credit unions.

- Over 250,000 volunteers serve as directors and committee members in these institutions. One-third of all credit unions have no full-time employees.

- Over 50 million American consumers are receiving financial services from over 18,500 credit unions (50% are under $1 million in assets).

- American consumers receive convenient and low cost services from their credit unions. Lower loan rates are available to members because of lower cost of operating credit unions. This is achieved in a large part by serving only members and because they are non-profit.

- In 1984/85, the credit union system used its resources to fully capitalize their central bank and their Federal insurance fund (NCUA). This action reduced the Federal deficit by $1 billion. If credit union growth is not interrupted by taxation, estimates show that further capitalization will reduce the Federal deficit an additional $1 billion by 1990 and by the year 2000, a total reduction of $9.2 billion.

- The credit union movement has always supported what is best for the American consumer even against its own immediate interests --
  Support for removal of Reg. Q.
  Support for S&Ls to get consumer loan powers.
  Support for truth-in-lending.

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*See 1984 Annual Report of the National Credit Union Administration.

- The credit union system has stressed credit union cooperation, not credit union competition. Like the other systems, it has been subjected to severe economic shocks. A crisis of confidence has been avoided because of working together.

A policy change toward such a system could only be justified by enormous revenue gains. Since the best income projections are so limited, the only signal sent by removing the exemption would be discontinuance of Federal policy.

Disruptions from Policy Reversal

The following are the anticipated disruptions in the credit union system resulting from a policy reversal on taxation.

- The safety and soundness implications are seriously troublesome. Since credit unions have no capital stock, they must use their undivided earnings as a means of preparing for major changes or unexpected market forces. The impact of the Treasury II plan on overall credit union equity would be devastating. For example, if the plan had been in effect during the period 1979-84, the cumulative reduction in overall equity (reserves and undivided earnings) would have been 20%. In other words, taxation would reduce the present equity level of the credit union movement from 7.1% ($8.1 billion) of assets to 5.7% ($6.6 billion). This is at a time when the FDIC is recommending an increase in the minimum capital level for banks to 9% and when the S&L industry is desperately seeking new forms of capital. Potential Federal government liability to guarantee the soundness of credit unions is dramatically increased.

  Further, taxation has to strike at the heart of the system's willingness to take care of its own problems and, instead, look to the Federal government for protection and continuance of its share of the financial market.

- In order to minimize the impact of taxation, individual credit union managers will be forced to adopt a tax avoidance strategy. All management decisions will be tempered by their tax implications. Almost instantly, credit union management will become "profit-driven."

- Pressure will mount to eliminate free and "unprofitable services." Small loans, financial counseling, low balance share draft (checking) accounts, and no-fee accounts are obvious potential victims of such pressures.

- To seek out the more "profitable" accounts, pressure would soon arise to permit credit unions to establish a traditional business relationship with the general public.

- As part of this trend, we will likely see the loss of the volunteer force within the movement as a direct result of taxation. The loss of volunteers and the volunteer spirit could be one of the most expensive social costs of taxation.

- The overall financial condition of the system will feel the impact of collective decisions to increase yield by increasing risk. This danger is minimal in a "member-driven" system which accounts, in a significant part, for today's relative health in the credit union movement. Unlike banks and S&Ls, credit unions have not been pressured into a situation where risky loans or investments appear to offer the only possible solution.

- The financial and paperwork burdens of Federal taxation will be exacerbated as individual states assert their prerogatives to impose their form of credit union taxation.

- This expanding and reliable "well" of low cost consumer credit will be capped and rendered obsolete.

CUNA STATEMENT BEFORE HOUSE SUBCOMMITTEE ON ECONOMIC STABILIZATION

Credit Union National Association, Inc.

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May 14, 1985

Honorable John J. LaFalce, Chairman
Subcommittee on Economic Stabilization
Committee on Banking, Finance and Urban Affairs
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to provide you this letter on behalf of the Credit Union National Association, Inc. (CUNA) for the record of your Subcommittee's hearings on the "Consequences of the Treasury Tax Plan for the Banking Industry." CUNA is an association of credit union leagues in each state, the District of Columbia, and Puerto Rico. Through these leagues, CUNA represents approximately 18,500 federally and state chartered credit unions which serve more than 50 million individual members.

The significance of the Treasury proposal for credit unions is unlike that for any other segment of the financial community. For credit unions, this is not a series of revisions in existing tax provisions--some positive and some negative. For credit unions, the Treasury proposal constitutes a complete reversal of established public policy toward the credit union movement. I hope this letter convinces you and the members of your Subcommittee of the tremendous social costs associated with such a policy reversal. It is CUNA's position that: the credit union movement is the healthiest financial system presently in existence; that Federal policy contributes significantly to this condition; that many socially desirable benefits stem from this policy; that policy reversal will undo the fundamental nature of this system; and that the price paid by undoing the system will dwarf the very limited revenue projections of taxing credit unions. Let me explain.

The Treasury proposal, and certain other bills already introduced in this Congress, would reverse a 48-year old public policy decision concerning the credit union movement in this country. This decision, to exempt the income of credit unions from taxation, was deliberated and affirmed in 1937. This was three years after enactment of the Federal Credit Union Act in 1934. The original act permitted states to tax credit unions on the same basis as banks. This was generally done on the basis of share capital. Since by law credit unions cannot accept deposits, all shares were

vulnerable to taxation. The tax burden became so oppressive, the Congress established the policy of tax exemption in 1937.

The policy was adopted by the Congress to encourage the success of the credit union movement in order to bring financial services to those who were at a disadvantage in obtaining them elsewhere (hourly wage earners, military, elderly, students, etc.) and to develop a credit union system as an alternative to the traditional "for profit" banking system. In 1951, this policy was reviewed by the Congress and reaffirmed. Because of this policy, there now exists a reliable and rapidly growing source of low cost consumer credit (presently over $100 billion). This system is dedicated by law to the extension of consumer credit.

The tax exempt policy was based on the fact that credit unions are organized and operated on a non-profit basis. They have no capital stock, they are mutually controlled, they are directed by volunteers, and most have close relationships with sponsoring companies. These conditions remain true today. Therefore, Mr. Chairman, I believe the decision before the Congress is not whether credit unions still qualify for the exemption (which they do), but whether the exemption is still warranted. This, of course, is a matter for the Congress to decide but I personally feel the answer is an obvious yes.

Because of the continuous support and encouragement of the Congress, the credit union movement has succeeded in reaching the lives of millions of Americans. This cooperative form of financial services delivery is not profit-driven but rather is fueled by the goal of being of service to members. A necessary ingredient in its success is the continued awareness by government decision-makers of the unique difference between "profit-driven" and "member-driven." Taxation, in addition to its onerous financial and paperwork burdens, would send a clear signal that the Federal government no longer sees nor encourages this alternative for American consumers. It is ironic that this could occur at a time when the Congress is considering a requirement for banks to provide lifeline and other consumer services.

The following social/economic benefits have been realized by a policy which has encouraged the formation of a credit union system:

- The credit union financial system is in excellent financial condition.* Because of its willingness to manage its own problems, there exist no major potential Federal liabilities due to industry crises. This is not true of other systems.

- Through mutual self-help, there is now in place a separate system to meet the liquidity, regulatory, information, and insurance needs of all credit union members.

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*See 1984 Annual Report of the National Credit Union Administration.

- Close personal service is given to all members regardless of their income or size of accounts. This includes financial counseling and the promotion of good credit and savings habits. Basic lifeline services are always available to members of credit unions.

- There are over 250,000 volunteers serving as directors and committee members in these institutions. 33% of all credit unions have no full-time employees.

- Over 50 million American consumers are receiving financial services from over 18,500 credit unions (50% are under $1 million in assets).

- American consumers receive convenient and low cost services from their credit unions. Lower loan rates are available to members because of lower cost of operating credit unions. This is achieved in a large part by serving only members and because they are non-profit.

- In 1984/85, the credit union system used its resources to fully capitalize their central bank and their Federal insurance fund (NCUA). This action reduced the Federal deficit by $1 billion. If credit union growth is not interrupted by taxation, estimates show that further capitalization will reduce the Federal deficit an additional $1 billion by 1990 and by the year 2000, a total reduction of $9.2 billion.

- The credit union movement has always supported what is best for the American consumer and not its own self interests --
  Support for removal of Reg. Q.
  Support for S&Ls to get consumer loan powers.
  Support for truth-in-lending.

- The credit union system has stressed credit union cooperation. It is not based on credit union competition. Like the other systems, it has been subjected to severe economic shocks. A crisis of confidence has been avoided because of working together.

The following are the anticipated disruptions in the credit union system resulting from a policy reversal on taxation.

- The safety and soundness implications are seriously troublesome. Since credit unions have no capital stock, they must use their undivided earnings as a means of preparing for major changes or unexpected market forces. Tables I-III show the impact on the credit union movement of a 33% tax rate. The results show a cumulative reduction in undivided earnings of 66.4% during the

period 1975-1984. During the same period, the cumulative reduction in overall equity (reserves and undivided earnings) is 25.4%. In other words, taxation would reduce the present equity level of the credit union movement from 6.3% ($7.2 billion) of assets to 4.7% ($5.3 billion). This is at a time when the FDIC is recommending an increase in the minimum capital level for banks to 9% and when the S&L industry is desperately seeking new forms of capital. Potential Federal government liability to guarantee the soundness of credit unions is dramatically increased.

Further, taxation has to strike at the heart of the system's willingness to take care of its own problems and, instead, look to the Federal government for protection and continuance of its share of the financial market.

- In order to minimize the impact of taxation, individual credit union managers will be forced to adopt a tax avoidance strategy. All management decisions will be tempered by their tax implications. Almost instantly, credit union management will become "profit-driven."

- Pressure will mount to eliminate free and "unprofitable services." Small loans, financial counseling, low balance share draft (checking) accounts, and no-fee accounts are obvious potential victims of such pressures.

- To seek out the more "profitable" accounts, pressure will soon arise to permit credit unions to serve the general public.

- As part of this trend, we will likely see the loss of the volunteer force within the movement as a direct result of taxation. The loss of volunteers and the volunteer spirit could be one of the most expensive social costs of taxation.

- The overall financial condition of the system will feel the impact of collective decisions to increase yield by increasing risk. This danger is minimal in a "member-driven" system which accounts, in a significant part, for today's relative health in the credit union movement. Unlike banks and S&Ls, credit unions have not been pressured into a situation where risky loans or investments appear to offer the only possible solution.

- The financial and paperwork burdens of Federal taxation will be exacerbated as individual states assert their prerogatives to impose their form of credit union taxation.

- This expanding and reliable "well" of low cost consumer credit will be capped and rendered obsolete.

In closing, Mr. Chairman, I would ask the Subcommittee to give its full consideration to what we have set forth in this letter. We are being asked to consider taxation as a means of contributing perhaps $200-$500 million per year to Federal revenues. If that were the only cost of this proposal, I might have responded differently. Having spent the last 29 years in the credit union movement, however, I sincerely believe that the real choices are accurately portrayed in this letter.

I thank you for the opportunity to present the views of our association.

Sincerely,

Harold T. Welsh
Chairman

CREDIT UNION SERVICE TO CONSUMERS AND COMMUNITIES

Summarized below are examples of credit unions providing services to their members and communities which go beyond what is expected of financial institutions. Many of these credit unions are among the largest, illustrating that credit unions do not stop behaving like credit unions when they reach a certain asset size.

Utah (Senator Jake Garn)

In Utah, Kennecott Copper, a major employer, is in the process of a shutdown affecting the jobs of thousands of workers. Many of the members of the Cyprus Credit Union in Magna, Utah are employees and former employees of Kennecott. Over the past several years, during extensive layoffs, the $54 million credit union has helped between 2,500 and 3,000 of those affected by the layoffs. Cyprus Credit Union has extended the period of their loans, reducing their monthly payments, and has allowed many members to postpone loan payments for several months. This flexibility on the part of the credit union helps these workers while they try to find other employment.

Wisconsin (Senator William Proxmire)

Antigo Credit Union is a $50 million credit union serving a county-wide community in rural Wisconsin. The field of membership includes a number of retired persons, many of them retired farmers. The credit union offers a debt amortization program to people with serious financial problems--a program that includes financial counseling. Antigo Credit Union is the only financial institution in the area offering this service at no cost.

Enclosure III

Pennsylvania (Senator John Heinz)

The $70 million Philadelphia Federal Credit Union was one of the first financial institutions to install special braille-equipped automated teller machines for its visually handicapped members.

In another demonstration of community service, the North Pittsburgh Telephone Employees Credit Union has been offering interest-free loans to members who were victims of the tornados that recently ravaged parts of Pennsylvania.

New York (Senator Alfonse D'Amato)

Union Settlement Federal Credit Union serves East Harlem, one of New York City's poorer neighborhoods. "With nowhere else to turn except to a neighborhood loan shark or a high-interest credit store, we are the community's alternate economic system," the credit union's former president, Maria Rodriguez, told New York Magazine. To wit, the credit union makes loans to welfare recipients—to whom no one else will lend—and has discovered they have a substantially lower delinquency rate than many other borrowers. The credit union has helped a local nursery school struggling to pay its taxes. It assisted in rebuilding an indoor ethnic stall market, after the 112th Street complex was ravaged by fire 10 years ago. More recently, the credit union helped a local development group renovate abandoned brownstones.

Washington (Senator Slade Gorton)

TAPCO Credit Union in Tacoma provides free bus tickets to retired members upon request. The credit union has an arrangement with the local transit

company to purchase the tickets at a 20% discount. Retired members can pick them up at the teller counters each time they visit the credit union.

Georgia (Senator Mack Mattingly)

HEW Atlanta Federal Credit Union, with $13.7 million in assets, serves the Social Security Administration and other public service employees in the Atlanta area. Periodically federal employees find themselves victimized by Congressional budget debates; occasionally a time lag develops between a payday and Congressional approval of the federal budget for the next fiscal year. At times like this, HEW Credit Union, as well as the $65 million Albany Government Employees Federal Credit Union, waive loan payments and make interest-free loans to members who need cash for immediate expenses and obligations. These periods have lasted several weeks, and each time the credit unions were there to provide financial security to these employees.

The B.O.N.D. Community Federal Credit Union was set up to serve a low-income area of Atlanta, the Grant Park or Little Five Points neighborhood. Many of the homes in the community were badly in need of repair, but many banks and S&Ls either were pulling out of the area or were reluctant to loan money to low-income people. The credit union offered home improvement loans to low-income residents, working with community groups to ensure that repairs and alterations maintained the historical integrity of the buildings. The program has revitalized the community. Today the area is one of the most attractive historic districts in Atlanta.

Nevada (Senator Chic Hecht)

In April 1985, Las Vegas musicians went on strike. Their credit union, Musicians Federal Credit Union, conducted a weekly drawing to give striking members a $50 food coupon good at a local supermarket. More important, the credit union did not ask members to make loan payments during the strike, and when the strike ended the credit union voluntarily extended the terms of the the loans of striking members so that none would fall delinquent as a result of their walkout.

A similar tale unfolded during a strike of kitchen workers, waiters and waitresses, who account for 70% of Las Vegas' hotel and casino industry personnel. The $13.8 million MGM Grand Federal Credit Union opened a special office off the hotel premises to serve striking members who could or would not cross the picket lines. This action is particularly significant in light of the close relationship which usually exists between credit unions and their sponsors.

Texas (Senator Phil Gramm)

Windthorst is a small farming community in North Central Texas. It is so small that it has no banks--the only financial institution serving the town is the $10 million Windthorst Federal Credit Union. But the credit union doesn't take its de facto monopoly position for granted. Far from it. Every Monday, the credit union sends a staff member to the community's one school to accept deposits and issue withdrawals to school children ranging in age from 6 to 16.

California (Senator Alan Cranston)

The area served by the $36.5 million Coast Central Credit Union in Eureka, California has had been experiencing a higher-than-average incidence of

missing children. The credit union initiated a child protection program for the community, in cooperation with the local police department. A child can come into the credit union, have a photo and fingerprints taken, and receive a laminated identification card. The cards are inserted into luggage-type tags and can be attached to the child's belt loop or jacket. The police also receive a copy of the I.D. In the first year of the program, the credit union prepared I.D. records for 3,200 children, including the children of non-credit union members.

Michigan (Senator Donald Riegle)

PARDA Federal Credit Union in Rochester, Michigan has set up a job placement service for the credit union's retired members. PARDA, with assets of $28.9 million, serves the employees and retired employees of the Parke Davis-Warner Lambert pharmaceutical complex. The credit union established the Senior Citizens Placement Center to find temporary jobs for retirees at the sponsor company and with other employers in the community. The program is promoted at monthly meetings of the credit union retiree club, the PARDA Senior Partners. Through this program, retirees can earn extra money and the community continues to benefit from their skills and experience.

Maryland (Senator Paul Sarbanes)

During the recent savings and loan crisis in Maryland, NASA Federal Credit Union, located in Riverdale, Maryland, initiated a program aimed at helping its members with deposits frozen in S&Ls. The $71 million credit union offered members loans at 10% when other financial institutions were charging 13-16% for funds.

A number of Maryland residents are members of the State Department Federal Credit Union. During the Iranian hostage crisis, this $149 million credit union helped its members who were involved in that situation by pulling their files, copying their statements for the period of their absence and then assigned special staff to serve as personal advisors for the returnees.

Connecticut (Senator Christopher Dodd)

Danbury Hospital Employees Federal Credit Union has been offering free checking (share draft) accounts to retirees and to members under the age of 19, since the checking program began.

Illinois (Senator Alan Dixon)

Diesel Credit Union in Countryside, Illinois formerly served the local General Motors plant exclusively. The $9 million credit union has expanded to include a number of small employers and organizations, including a rehabilitation center for physically and mentally retarded adults. The credit union takes special pains to serve these special members; it gives them counseling, including instructions on the most simple financial transactions, and employs some in the credit union office to perform such jobs as monthly statement stuffing.

Table 1
Summary

Credit Union Taxation - 1984 Data

	President's Proposal Case I	Taxation Under Existing Rules No Avoidance Case II	Taxation Under Existing Rules With Avoidance Case III
Approximate Tax Revenue	$350 Million	$400 Million	$310 Million
Number of Credit Unions Paying Tax	3,570	17,830	16,320
For Credit Unions Paying Tax:			
Tax as Percent of:			
Gross Income	3.2%	3.0%	2.5%
Operating Expenses	11.9%	10.7%	8.9%
Transfer to Undiv. Earnings	50.9%	47.1%	36.0%

Table 2

Tax Compared to Expense-to-Income Ratios

	Case I	Case II	Case III
Tax-to-Income	3.2%	3.0%	2.5%
Total Operating Expenses	27.0%	28.1%	28.1%
Member Insurance	2.0%	2.6%	2.6%
Occupancy	1.6%	1.6%	1.6%
Office Operations	5.3%	5.2%	5.2%
Compensation	13.1%	13.5%	13.5%
All Other	5.0%	5.6%	5.4%

Table 3

Ways to Increase Net Income Sufficiently to Pay
Tax Without Reducing Undivided Earnings Transfers

President's Proposal at 33% Rate

-Raise Loan Rates	90 Basis Points or
-Lower Dividend Rate	70 Basis Points or
-Raise Fees	Almost Triple or
-Reduce Operating Expense	by 18%

CASE I
PRESIDENT'S TAX PROPOSAL
1984 Data

GROSS INCOME: includes all income (including non-operating income)
NET INCOME: allows exclusion of operating expenses (excluding provision for loan losses), dividends, interest payments and net loan charge-offs
TAXABLE INCOME: equals net income
TAX RATE: marginal rates rising from 15% to 33% of taxable income
TAX AVOIDANCE POTENTIAL: Minimal
TREASURY REVENUE (1984): $350 million

		For Credit Unions Paying Tax:				
Asset Size ($ Millions)	Percent of Credit Unions Paying Tax	% With Tax Greater Than Transfers to Undiv. Ernngs	% With Neg. Transfers to UDE Paying Tax	Tax as Percent of Gross Income	Tax as Percent of Transfers to Undivided Earnings	Average Tax
$ 0.0 - 0.2	0.0%	0.0%	0.0%	0.0%	0.0%	$ 0
0.2 - 0.5	0.0	0.0	0.0	0.0	0.0	0
0.5 - 1.0	0.0	0.0	0.0	0.0	0.0	0
1.0 - 2.0	0.0	0.0	0.0	0.0	0.0	0
2.0 - 5.0	0.0	0.0	0.0	0.0	0.0	0
5.0 - 10.0	94.6	7.4	6.5	2.8	37.5	23,600
10.0 - 20.0	94.8	9.8	4.4	3.3	46.4	55,700
20.0 - 50.0	96.0	14.0	6.5	3.3	51.4	120,500
50.0 & Over	98.7	16.5	5.5	3.2	56.2	432,300
TOTAL	19.3%	10.4%	5.8%	3.2%	50.9%	$ 98,800

Formula

Gross Income
- Operating Expenses
+ Provision for Loan Losses
- Net Charge-Offs
- Dividends & Interest
= TAXABLE INCOME

TAX RATES

Taxable Income	Tax
Below $25,000	15% of Taxable Income
$ 25,000 - $ 50,000	$ 3,750 + 18% of Taxable Income over $25,000
$ 50,000 - $ 75,000	$ 8,250 + 25% of Taxable Income over $50,000
$ 75,000 - $140,000	$14,500 + 33% of Taxable Income over $75,000
$140,000 - $360,000	$35,950 + 37.66% of Taxable Income over $140,000
Over $360,000	A flat 33% of Taxable Income

Run Date: May 19, 1985

CASE II
TAXATION UNDER EXISTING RULES - NO AVOIDANCE
1984 Data

GROSS INCOME:	includes all income (including non-operating income)
NET INCOME:	allows exclusion of operating expenses (excluding provision for loan losses), dividends, and interest payments
TAXABLE INCOME:	70% of net income (30% deduction substitutes for loan losses)
TAX RATE:	marginal rates rising from 16% to 46% of taxable income
TAX AVOIDANCE POTENTIAL:	investment tax credit on equipment purchases and auto leasing, investment in municipal securities
TREASURY REVENUE (1984):	$400 million

		For Credit Unions Paying Tax:				
Asset Size ($ Millions)	Percent of Credit Unions Paying Tax	% With Tax Greater Than Transfers to Undiv. Ernngs	% With Neg. Transfers to UDE Paying Tax	Tax as Percent of Gross Income	Tax as Percent of Transfers to Undivided Earnings	Average Tax
$ 0.0 - 0.2	92.3%	5.1%	13.0%	2.4%	22.6%	$ 300
0.2 - 0.5	95.6	5.6	9.9	2.2	21.8	900
0.5 - 1.0	96.4	4.6	8.9	1.9	20.7	1,700
1.0 - 2.0	97.1	5.2	9.7	1.8	21.6	3,100
2.0 - 5.0	97.6	4.5	8.1	2.0	24.9	7,700
5.0 - 10.0	98.0	7.4	8.0	2.4	33.8	20,500
10.0 - 20.0	99.5	11.2	6.5	3.0	44.5	50,200
20.0 - 50.0	99.0	14.6	8.4	3.3	53.6	121,100
50.0 & Over	99.7	19.7	6.2	3.5	61.2	460,700
TOTAL	96.4%	6.3%	9.4%	3.0%	47.1%	$ 22,600

Formula	Taxable Income	TAX RATES Tax
Gross Income	Below $25,000	16% of Taxable Income
- Operating Expenses	$ 25,000 - $ 50,000	$ 4,000 + 19% of Taxable Income over $ 25,000
+ Provision for Loan Losses	$ 50,000 - $ 75,000	$ 8,750 + 30% of Taxable Income over $ 50,000
- Dividends & Interest	$ 75,000 - $100,000	$16,250 + 40% of Taxable Income over $ 75,000
= Net Income	Over $100,000	$26,250 + 46% of Taxable Income over $100,000
x 0.7		
= TAXABLE INCOME		

Run Date: May 19, 1985

CASE III
TAXATION UNDER EXISTING RULES - WITH TAX AVOIDANCE
1985 Data

* Assumed tax avoidance is a 6% investment tax credit on 10% of auto loans converted to leases for CUs with over $1 million in assets.

GROSS INCOME: includes all income (including non-operating income)
NET INCOME: allows exclusion of operating expenses (excluding provision for loan losses), dividends, and interest payments
TAXABLE INCOME: 70% of net income (30% deduction substitutes for loan losses)
TAX RATE: marginal rates rising from 16% to 46% of taxable income
TAX AVOIDANCE POTENTIAL: investment tax credit on equipment purchases and auto leasing, investment in municipal securities
TREASURY REVENUE (1984): $310 million

		For Credit Unions Paying Tax:				
Asset Size ($ Millions)	Percent of Credit Unions Paying Tax	% With Tax Greater Than Transfers to Undiv. Ernngs	% With Neg. Transfers to UDE Paying Tax	Tax as Percent of Gross Income	Tax as Percent of Transfers to Undivided Earnings	Average Tax
$ 0.0 - 0.2	92.3%	5.1%	13.0%	2.4%	22.6%	$ 300
0.2 - 0.5	95.6	5.6	9.8	2.2	21.8	900
0.5 - 1.0	96.4	4.6	8.9	1.9	20.7	1,700
1.0 - 2.0	75.3	1.6	4.4	1.1	11.3	2,000
2.0 - 5.0	78.6	1.1	3.1	1.4	14.6	5,400
5.0 - 10.0	84.7	2.4	4.3	1.9	23.2	16,200
10.0 - 20.0	90.4	6.5	2.9	2.5	33.5	41,800
20.0 - 50.0	93.6	7.9	4.5	2.7	41.5	100,800
50.0 & Over	97.3	15.8	4.4	2.9	48.9	382,400
TOTAL	88.2%	4.4%	7.3%	2.5%	36.3%	$ 19,100

Formula

Gross Income
- Operating Expenses
+ Provision for Loan Losses
- Dividends & Interest
= Net Income
x 0.7
= TAXABLE INCOME

TAX RATES

Taxable Income	Tax
Below $25,000	16% of Taxable Income
$ 25,000 - $ 50,000	$ 4,000 + 19% of Taxable Income over $ 25,000
$ 50,000 - $ 75,000	$ 8,750 + 30% of Taxable Income over $ 50,000
$ 75,000 - $100,000	$16,250 + 40% of Taxable Income over $ 75,000
Over $100,000	$26,250 + 46% of Taxable Income over $100,000

Run Date: May 19, 1985

The CHAIRMAN. Thank you, gentlemen. I'm not sure I would agree that it was the biggest crisis because it comes up every year, so you're used to facing it. At this point I would not promise we would hold a separate hearing simply because the committee has been strongly in support of the Central Liquidity Facility, the $1 billion that was placed in that tradeoff, were not being taxed. At this point I don't necessarily think that it's necessary to hold a hearing to reiterate what we said last year and the year before and will report again to the Finance Committee and to the administration.

Senator Cranston, do you have any questions you wish to make?

Senator CRANSTON. No, I do not.

The CHAIRMAN. Senator Dodd.

Senator DODD. Really, Mr. Chairman, not so much a question. I know how fond you are of statements by members, but let me clear something up a little bit. I apologize to our earlier witnesses for arriving here a little late. I was involved in product liability questions and the Commerce Committee was holding a set of hearings on that issue this morning.

MARYLAND AND OHIO S&L PROBLEMS

I said something the other day, Mr. Chairman, about what we ought to be doing in terms of what's happened recently in Maryland and Ohio and other places. I didn't want to leave anyone unclear. Apparently I did. Some people believed that I had moved away from a position that I have held pretty strongly for the last couple years, and that is the need for a bill. What I was suggesting is that—and I may have used the words 6 months and if I did I wasn't suggesting that as a time, but rather the idea of taking a look at those situations to feel more secure.

My guess is that they are unique problems and that they are not systemic, but I would feel a lot better about that conclusion if there were just some way of examining that a bit closer. These gentlemen here I realize are not necessarily here to comment on those situations, but since you are here I will ask you whether or not you have looked at those two situations particularly and have drawn any conclusions? Is there something more systematic that the committee ought to be worried about or do you believe the Maryland and Ohio situations were created by unique situations in those States—bad management, fraud, State statutes that weren't secure enough or tight enough—or is there something going on out there that we ought to be far more conscious of that we are not paying attention to?

Mr. PERKOWSKI. Senator Dodd, let me try if I may, sir. Credit unions, of course, weren't involved in those situations.

Senator DODD. I understand that.

Mr. PERKOWSKI. I guess one of the reasons why they weren't involved is we have created our own system in the credit union movement and we have our corporate system and the U.S. Central Credit Union and most of our investments and reverse repos as a matter of fact are done within our own system. U.S. Central recently reached the $10 billion in assets and it was granted a AAA long-term rating by Standard and Poor and there's only one other finan-

cial institution—and I believe that's Morgan Guaranty—that has that kind of lofty long-term rating.

So I guess what I'm trying to answer to you, sir, is that because we keep our investment in-house, we keep most of them within our corporate system, we didn't get caught in a reverse repo that started that entire fiasco and really pulled that system down.

Senator DODD. But you watch the system. I realize you're here to talk about Federal credit unions, but I'm drawing on your expertise as someone involved in the general safety and soundness of financial institutions. What is your professional opinon of what is going on?

Mr. PERKOWSKI. We can only speak for our own and we think ours are the strongest, Senator.

Mr. HESS. Senator, certainly the recent situations in Ohio and Maryland have heightened the interest of our members who have had accounts, particularly here in the Washington area where they had access to Maryland chartered and insured institutions, but it's a little difficult to judge the impact because a number of people had earlier problems with the Maryland institutions and certainly remain aware of the difference between federally insured institutions and State-chartered institutions.

[The following supplement is submitted for the record:]

NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS
P.O. Box 3769 WASHINGTON, DC 20007
(703) 522-4770

June 24, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
534 Dirksen Senate Office Building
United States Senate
Washington, DC 20510

Dear Chairman Garn:

On Tuesday, June 18, Robert A. Hess testified on behalf of the National Association of Federal Credit Unions (NAFCU) before the Senate Committee on Banking, Housing and Urban Affairs. With your permission, I would like to provide supplementary information which I believe responds to an inquiry Senator Dodd directed to the credit union witnesses during the course of the hearing. I request that this letter be incorporated into the record of last Tuesday's hearing.

Senator Dodd asked the credit union witnesses what changes they would recommend in order to guard against future calamities such as those that recently befell the savings and loan industry in Ohio and Maryland. That is a very timely question. In fact, on June 12, the NAFCU Board of Directors instructed our Legislative Committee to conduct a comprehensive review of the law relating to the National Credit Union Share Insurance Fund (12 U.S.C. 1781-1790) and the Central Liquidity Facility (12 U.S.C. 1795-1795(k)).

When that review is completed we will convey our findings to you. Among the areas we will include in our review are issues dealing with CLF advances, as well as CLF investments. It is NAFCU's intention to invite representatives of the NCUA Board as well as representatives from our sister trade association, the Credit Union National Association (CUNA), to participate in this review. NAFCU solicits their opinions and viewpoints as we look into these issues. It is our hope to transmit preliminary findings to you in an expeditious manner.

On behalf of the members of the National Association of Federal Credit Unions I thank you for your strong support of the cooperative credit union system. If you have any questions concerning the issues raised in this letter or any other matter affecting our nation's credit unions, please contact NAFCU's Director of Government Affairs and Federal Legislative Counsel, Bill Donovan, at 522-4770.

Sincerely,

Kenneth L. Robinson

Kenneth L. Robinson
Executive Vice President

KLR:ejc

The CHAIRMAN. I might just say to the Senator that I didn't interpret his remarks in that way. As long as the Dodd amendment is in the legislation, I assure you I continue to back it.

Senator DODD. I'm not a doubting Thomas, but I would certainly like to see the loopholes closed in that bill. Thank you both. Thank you, Mr. Chairman.

The CHAIRMAN. I might just make one other comment, though. In getting to some of the issues that Senator Dodd was referring to, which is the reform of the depository institutions' insurance funds, I think it is necessary. I think we also need to look at the regulatory structure. In looking at S. 2851, that really should have been passed, in my opinion, last year. It was last year's bill. We are getting behind the power curve again and we ought to look at it and go ahead with the bill and pass it this year so we can move on with the issues that Senator Dodd was speaking about.

Senator DODD. I might add, it's indicative I think, Mr. Chairman, that the thrust of your testimony, Mr. Perkowski, is that the tax simplification bill—I, for one, believe, while that's a nice subject and an interesting one to look at, that that issue is one that seems to me you get involved in when you resolve questions like budget deficits, trade deficits, and financial institutions questions and it's moved up to No. 1, and I think that's reflected in your testimony.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Gentlemen, the President's budget as you know proposes to tax credit unions for the first time. Those with assets in excess of $5 million would be taxed. What percentage of credit unions have assets in excess of $5 million?

APPROXIMATELY 20 PERCENT WITH ASSETS OF $5 MILLION

Mr. PERKOWSKI. Senator, approximately 20 percent of the credit unions have assets of $5 million or more. However, that represents 80 percent of the assets and it represents about 40 million of the credit union members.

Senator SASSER. 40 million of whom?

Mr. PERKOWSKI. 40 million members are in 20 percent of the credit unions, of the 18,500 credit unions, approximately 3,000 credit unions, Senator.

Senator SASSER. Now the justification provided for this is that it's a matter of equity, that banks and thrifts pay taxes and therefore so should credit unions. Now we are not here this morning, of course, to discuss the tax bill, but the underlying question——

The CHAIRMAN. But we have at great length, so it's all right for you to go right ahead.

Senator SASSER. We want fair competition. How would you respond to the question of fairness and equity? If banks and thrifts are going to be taxed, why should credit unions continue to maintain a tax-exempt status?

Mr. PERKOWSKI. Senator, 48 years ago, in 1937, when Congress issued the tax exemption for credit unions, credit unions were a nonprofit financial organization, financial co-ops. Our policymakers were volunteers. Our primary purpose was to provide savings service and loan service to our members, not customers. Our policies

was to give the best possible financial service that we could give to the members.

And I submit to you, sir, that we have not changed in our mission. Those same things that were there and appropriate in 1937 exist today and we have not changed the way we serve our members and if that was sound public policy then, we certainly would hope that it would remain sound public policy today.

Senator SASSER. You may have answered this earlier but I would like to get the answer myself. What impact on the structure or operations of the credit unions industry or credit union movement as a whole would these taxes have if they were proposed?

Mr. PERKOWSKI. Just viewing them over the past 5 years with the Treasury II proposal, we would see a 20-percent reduction of our retained earnings which is part of our equity and we currently boast of an equity ratio of 7.1 percent of assets. That's our regular reserves and undivided earnings. By the way, it's the only way we can generate equity. We have no external source or external means of generating equity. We can only generate it from our earnings.

Had we been taxed under Treasury II for the last 5 years, that would have decreased by 20 percent or our equity ratio would have been at 5.7 percent today.

Senator SASSER. Do you have any figures which would indicate what percentage of earnings on credit union funds go for administrative costs or overhead?

Mr. PERKOWSKI. Are you referring to our expense ratio, Senator?

Senator SASSER. Yes.

Mr. PERKOWSKI. I think generally the expense ratios of credit unions in the $5 million and above category are in the 35 percent nature. That does not include cost of funds. That is pure operational expense.

Senator SASSER. Well, what I'm driving at is that I want to find out how much volunteer work we still have going on and how much of it is just wholly a professional staff operation. I'm very sympathetic to the concept in the early days of the credit union movement when it was a banding together of people to try to pool assets so that some credit would be available to their particular group which otherwise would not have been available because they could not get loans elsewhere. I'm sympathetic to special dispensations that were made to the credit union movement at that time and sympathetic to that dispensation continuing if credit unions are still configured principally the way they were initially. But it becomes a little more difficult to defend these special dispensations as the credit union gets larger and larger and is run principally by a professional staff, or totally by a professional staff, and volunteers become sort of figureheads.

Mr. PERKOWSKI. Senator, I don't happen to feel the philosophy of credit unions changes with their asset levels. As a matter of fact, let me——

Senator SASSER. Well, you can convince me of that.

Mr. PERKOWSKI. Let me try to, Senator. The largest credit union in the United States isn't too far from here, Navy Federal, and it has something like $1.5 billion in assets. Navy Federal has approximately 700,000 members, most of which are enlisted. They have 300,000 accounts, Senator, with less than $100 in their statement

balances and they have over 130,000 accounts with less than $10 in their savings balances. They have very little in the area of fees. They are open to serve their members 24 hours a day, 365 days a year, and have told us on last Christmas Day they made 50 loans to their members. And I submit there aren't very many $1.5 billion banks that I think would treat their customers the same way.

Mr. HESS. Senator, I think another indication too of the role of the volunteer is the fact that there are still some 250,000 volunteers serving credit unions across the Nation today and more than one-third of all credit unions are totally run by volunteers.

Senator SASSER. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sasser.

Gentlemen, we appreciate your being here today.

Senator Dixon was here earlier and was not able to stay. He asked me if I would place a statement in the record. It's very brief and I would ask unanimous consent that it be placed in the record prior to any of the testimony of the witnesses.

But it's such a good statement, rather than placing it in the record I would like to read it and then have it placed in its proper perspective in the record.

Mr. Chairman, we have a very distinguished group of witnesses before the committee this morning, and I look forward to hearing their testimony.

This is the seventh in a series of hearings on the problems and changes affecting the financial services industry. These hearings are in addition to the numerous hearings that were held in the last Congress on many of the same basic issues, and to the hearings held back in 1981 and 1982 on the same subject areas.

Even this very short summary of the committee's work demonstrates that there has been no attempt to act in a hasty manner without having a proper factual foundation. Indeed, the committee, in my view, has gone more than the last mile in an attempt to be fair to every party with an interest in financial services legislation.

The committee has the evidence; now is the time to act. We cannot afford further delay. Continuing to permit the future structure of the financial services industry to be determined by those most able to exploit the loopholes in current statute represents a bankruptcy of the legislative process. We need to address the issues before us and enact necessary reforms.

Last year's Senate bill, which passed by an overwhelming vote of 89 to 5, provides a reasonable basis for action this year. I am hopeful that this committee will report a bill soon that is along the lines of last year's bill, and that we will get quick action on the Senate floor and an early conference with the more limited bill that now seems to be moving in the House.

I look forward to continuing to work with this morning's witnesses and all interested parties in an effort to achieve prompt enactment of a bill that represents a reasonable answer to the problems facing the financial services industry today.

Senator Dixon has certainly summed up my feelings after all of these years of holding hearings and attempting to get Congress to make some decisions, and these two double-spaced pages sum up the entire situation. That's why I wanted to end the hearing today with his statement where he was not able to be here to deliver it himself.

Thank you very much, gentlemen.

The committee is adjourned.

[Whereupon, at 11:10 a.m., the hearing was adjourned.]

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

PART II

WEDNESDAY, JUNE 19, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met, at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Mattingly, Hecht, Proxmire, Riegle, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The committee will come to order.

We continue our oversight hearings on changes in the financial services industry. We have already heard from the regulators, diversified financial service providers, Treasury, and various industry consultants.

In this phase of these hearings which started yesterday we are hearing the testimony of participants in the financial services industry.

Yesterday we heard from panels representing the thrift industry, the mortgage banking sector, and the credit unions.

Today we will be receiving evidence from bankers and insurance underwriters and agents.

As everyone probably knows by now, my interest in the financial services industry was really started in my youth in the insurance industry when I still had hair.

Senator HEINZ. And in a galaxy far, far away a long time ago. [Laughter.]

The CHAIRMAN. It's interesting you would mention that, John, because I'd like to say I'm happy to be here today, but I did not say that at the start of my remarks because Discovery is flying again today, and I would much rather be there and I can't tell you how sincerely I mean that. Rather than being here in the Senate, I spent 4 months with people knowing what they were doing.

Senator MATTINGLY. What I might add, weren't you trained to get sick?

The CHAIRMAN. No, I had already been trained by serving here for 10 years. As a matter of fact when I first went to Houston when I started my disorientation training I told them I didn't need that phase of the training, I spent 10 years in the Senate.

51-337 O—85——14

Senator HEINZ. If you ever do get to go up again I think we can probably do better on the resolution welcoming you back.

The CHAIRMAN. I'll take anything I can get. We do have a very large group today and three different panels besides this one, but I would like to take a minute to introduce our distinguished witnesses and to welcome them and thank them for taking the time to appear before the committee today.

On the first panel we have eight witnesses. In no particular order, they are James Cairns, president of Peoples National Bank of Washington in Seattle, better known to all of us as the president of the American Bankers Association; B.F. Backlund, president, Bartonville Bank in Peoria, president of the Independent Bankers Association of America; Kenneth L. Roberts, chairman, First American Corp., Nashville, chairman, Association of Bank Holding Cos.; accompanied by John LaWare of the Association; Morgan Stark, managing director capital markets group, Chemical Bank, now serving as president of the Dealer Bank Association; William S. Edgerly, chairman of the board and president, State Street Bank & Trust Co. of Boston, representing the Association of Reserve City Bankers; William J. Stallkamp, senior vice president, Mellon Bank, on the board of directors of the Consumer Bankers Association; Bill Hickman, president of the Dixie State Bank from my own home State, and president of Western Independent Bankers; and Walter J. Connolly, chairman of the CBT Corp., appearing on behalf of the Coalition for Regional Banking & Economic Development.

Our second panel, our insurance underwriting panel, includes John B. Carter, president of the Equitable Life Assurance Society appearing on behalf of the American Council of Life Insurance; and John B. Crosby, general counsel, National Association of Independent Insurers.

The third panel includes William T. Huntley III, of the National Association of Casualty & Surety Agents; Richard G. Taylor, president-elect of the Independent Insurance Agents of America, another friend and colleague of mine from Utah. I'm proud to have him here today. Joseph H. Dimond from Detroit, on behalf of the National Association of Insurance Brokers; Kirk R. Englehardt, from Salt Lake City, on behalf of the National Association of Life Underwriters; David L. Ream, from Cleveland, representing the National Association of Professional Insurance Agents; and George T. Moran, on behalf of the National Association of Surety Bond Producers.

I am happy to welcome all three panels before us today and obviously with the number of witnesses I would expect that you would summarize your statements. We will include the complete statements of all witnesses in the record.

Before I turn to any of you gentlemen, I'd like to turn to any of my colleagues that have any opening statements they wish to make.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, today we continue the Banking Committee oversight hearings on the financial services industry. Today's hearing is the eighth such hearing on financial services.

Senator Garn, I would like to commend you for conducting these hearings and also welcome the witnesses before us today. I understand the schedules these important individuals have and I appreciate their taking time out of their schedules to meet with this committee. I believe the testimony of the panel will enlighten the committee on how to deal with the problems and answer the questions facing the financial services industry today.

It seems almost everyday an article appears in the news concerning the present state of the financial services industry in this Nation. Whether it is an article concerning the failure of privately insured savings and loans, disturbances in the Government securities market, or interstate banking, the financial services industry is a much discussed topic. In many of these areas the financial services industry is showing signs of strain and those concerned with the financial well-being of the industry are beginning to worry.

I believe through this set of hearings many of the problems facing the industry can be solved. The testimony provided by the witnesses will serve this committee's attempt to develop legislation which is both safe and fair to both the consumer and the financial institutions.

Thank you, Mr. Chairman.

Senator HEINZ. Mr. Chairman, I don't have an opening statement, but I would just like to take note of one of our witnesses, Bill Stallkamp, a neighbor of mine in Fox Chapel. It's extraordinary that there's two witnesses from Utah, but it's even more extraordinary that there's one from Fox Chapel which is even smaller than Utah.

The CHAIRMAN. Well, I just think you have to notice the positions those two Utahans hold to know why they are here. Utahans rise to the top.

Senator HEINZ. They do, Mr. Chairman, and I don't expect that to change. But I do want to say that Bill, who will be testifying, is a senior vice president of Mellon Bank, and is department head of the financial institutions department of that fine institution. He's been a resident of the Pittsburgh area for approximately 13 or 14 years, and been with Mellon Bank some 23 years. That's extraordinary for those of us who think in terms of 6-year job commitments, and he's here testifying for the Consumer Bankers Association and I'm glad to have him here.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Mr. Chairman, I want to welcome before the committee this morning a law school classmate of mine, Kenneth Roberts, from Nashville, TN. We were at law school together and he went on, Mr. Chairman, to become a great success and become chairman of the First American Corp. of Nashville, TN, and, unfortunately, I fell into disfavor and went into politics. But we are delighted to have Ken Roberts here today appearing as the president and chief executive officer of First American Corp., and also, Mr. Chairman, as the chairman of the Association of Bank Holding Co's. So I want to extend a personal and warm welcome to him this morning.

Senator MATTINGLY. I'd just like to say, Mr. Chairman, that I also have a constituent here, Mr. Bill Huntley, from Atlanta, GA, and I have a statement for the record in reference to him but it

only takes one from Georgia to offset two from Utah. End of comment. I was waiting for you to retaliate. Do you have a comment?

The CHAIRMAN. I don't have time to with all these witnesses.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No statement.

The CHAIRMAN. Mr. Connolly, would you like to begin?

STATEMENT OF WALTER J. CONNOLLY, JR., CHAIRMAN, CBT CORP., HARTFORD, CT; ON BEHALF OF THE COALITION FOR REGIONAL BANKING & ECONOMIC DEVELOPMENT

Mr. CONNOLLY. Thank you, Senator.

Mr. Chairman and members of the committee, I am Walter J. Connolly, Jr. I note your statement as chairman of the CBT Corp., but as a result of the Supreme Court decision 1 week ago Monday, the CBT Corp. and the Bank of New England Corp. carried out the first interstate banking merger under the New England regional experiment legislation which was passed by the States of Connecticut and Massachusetts and so I now am chairman of the Bank of New England Corp.

REGIONAL BANKING IN NEW ENGLAND

I am here representing my own views, those of the Bank of New England Corp., and those of the Coalition for Regional Banking & Economic Development.

Last Friday, after 2 years of legal challenge and delay, the merger of Bank of New England Corp. and CBT Corp. was finally accomplished. That was accomplished as a result of the Supreme Court decision in the case of *Northeast Bancorp* v. *the Board of Governors* which unanimously confirmed the constitutionality of Connecticut and Massachusetts legislation permitting interstate banking on a reciprocal basis within the six-State New England region.

We were able to accomplish this merger first because ours was the first interstate merger announced under this kind of legislation and we were a party to the Supreme Court case.

The new Bank of New England Corp. creates a strong regional bank, which may sound impressive until you consider that it represents only a small fraction of the resources of any one of our Nation's largest banks.

Therein lies the central question which concerns all of us—what degree of concentration of banking assets, in what geographic patterns, and within what structure of Federal and State control, is proper and appropriate in the public interest?

And I have submitted in my statement and I won't reiterate that this isn't a new question. It's as old as Alexander Hamilton and Thomas Jefferson who fought over the creation of the Bank of the United States, our first interstate bank, which was later struck down by Andrew Jackson in 1833 shortly after his reelection, when he administered the death blow to the bank by withdrawing the public deposits saying as he did so, among other things, "One of the most serious objections to the bank is the power which it concentrates." And without going into historic precedent, I'm sure the committee is familiar with that.

Geographic restrictions, though, have been largely responsible for the local orientation of the American banking system. Bankers and their customers live in the same communities and know each other. That's the way we do business in Connecticut and that's the way the Bank of New England will be doing business in New England. Credit is granted locally. Crucial decisions affecting the future of individuals and businesses, sometimes of entire communities, are made on the basis of personal knowledge, and not merely on a review of financial statements at bank headquarters in distant cities.

Writing for a unanimous court in last week's decision, Justice Rehnquist noted that the court had already stated that "banking and related financial activities are of profound local concern." He went on to say: "This statement is a recognition of the historical fact that our country traditionally has favored widely dispersed control of banking."

However, he also observed that during the 1970's the New England States found themselves faced with growing competition from nonbank financial companies not confined within State lines and they therefore sought an alternative that would allow expansion beyond their borders—the borders of the States in which they were domiciled—without opening their borders to unimpeded interstate banking.

The Connecticut General Assembly established a commission called the Hebb Commission in 1979 to study the problem of interstate banking and this commission concluded in its 1983 report that at the national and State levels the philosophy underlying our structure of bank regulation has been to promote a pluralistic banking system. The promotion of local ownership and control of banks has as one of its objectives the preservation of a close relationship between those in the communities who need credit and those who provide credit. To allow the control of that credit, essential to the health of our economy, to pass to hands that are not immediately responsive to the interests of Connecticut citizens and businesses would not, we believe, serve our State well.

So the commission delivered its report in January 1983 and its recommendations for new regional interstate banking legislation were enacted by the Connecticut Legislature at about the same time that the Massachusetts Legislature enacted similar legislation. These statutes became known as the New England experiment, and that New England experiment has now been affirmed by the Supreme Court. The justices were unanimous in their finding that the history of the Douglas amendment indicates the intent of Congress to allow each State flexibility in its approach, and that the Connecticut and Massachusetts laws allowing only regional acquisitions are consistent with the Douglas amendment's and the Bank Holding Company Act's purpose of retaining local, community-based control over banking.

Now I don't appear before you this morning as an advocate of regional interstate banking. Rather, I am here as a proponent of an experiment. The first recommendation of the Hebb Commission, to which I referred, was as follows:

> An experiment in interstate banking would be desirable. By "experiment" we mean a first step toward interstate banking that would allow limited entry by out-

of-state banking organizations and would afford the legislature an opportunity to make its own calculus of the benefits and detriments that might result from a broader program of interstate banking.

And that's exactly what we are engaged in. An experiment, by definition, is a test, carried out under controlled conditions to confirm a theory or hypothesis and see what its effects may be. It was the conclusion of the Hebb Commission and the spirit of the Connecticut and Massachusetts legislation that trial and experiment on a regional basis would be entirely appropriate and begin the process of a deliberate evolution to full interstate banking, and that's especially true when the potential consequences of legislative action at the Federal level are as sweeping as they are in this instance.

Now last Thursday, Secretary Baker appeared before your committee and stated the administration's support for the concept, I believe—or as reported in the press—for the concept of full interstate banking. The New England experiment also supports this concept. However, even if the Congress ultimately accepts the Secretary's recommendation, it still leaves unanswered the questions of how do we get there and how fast?

EXPERIMENT HAS JUST BEGUN

I would submit that it's really much too early to say how we get there and how fast. Let's remember that the experiment, which was delayed by more than 2 years of legal struggle, has only just begun. In fact, it's only 2 days old. In New England, in fact, it began when CBT Corp. and the Bank of New England merged to form the Bank of New England Corp.

We are a considerable time away from any real assessment of the results and during these coming months there may be many other States and many other regions that are going to be embarking on their own experiments. I suggest that we wait for the results. It hardly seems wise or necessary to prejudge or try to anticipate the outcome of the experiment that's only begun. Certainly the public is not clamoring for action. There is nothing to be gained, and much that could be lost, in considering interstate banking legislation without the benefits of the coming regional experience.

Mr. Chairman, I can only echo your own comment of last week as reported in the press. We see no need for an interstate banking provision in your legislation this year. We think the question has been settled for the interim by the Supreme Court. On the other hand, we recognize that Congress and only the Congress will ultimately determine, after due consideration, whether it's best to continue to leave the structure of banking up to the States or to make it a matter of national law.

In either event, we look forward to participating with you in your further studies and deliberations of interstate banking issues. Certainly we will always be ready and willing to share with you the results of our own New England experiment as they develop.

Thank you very much.

[The complete prepared statement follows:]

STATEMENT

OF

WALTER J. CONNOLLY, JR., CHAIRMAN

BANK OF NEW ENGLAND CORPORATION

ON BEHALF OF THE

COALITION FOR REGIONAL BANKING

AND ECONOMIC DEVELOPMENT

Mr. Chairman and members of the Committee, I am Walter J. Connolly, Jr., Chairman of the Bank of New England Corporation.

I am here representing my own views, those of the Bank of New England Corporation, and those of the Coalition for Regional Banking and Economic Development. The Coalition was founded in early 1984 to represent the rights of our states to enact regionally reciprocal banking laws. The Coalition's members include state banking associations and individual banks of all sizes from various sections of the country.

Last Friday, after two years of legal challenge and delay, the merger of Bank of New England Corporation and CBT Corporation -- the parent of The Connecticut Bank and Trust Company -- was finally accomplished. The last obstacle to our combination was removed earlier last week when the Supreme Court, in Northeast v. Board of Governors, unanimously affirmed the constitutionality of Connecticut and Massachusetts legislation permitting interstate banking on a reciprocal basis within the six-state New England region. Ours is the first merger to actually take place following that decision. This is because ours was the first interstate merger announced under the provisions of the Connecticut and Massachusetts laws, and we were a party to the Supreme Court case.

The merger of Bank of New England Corporation and CBT creates a strong regional banking team with assets on the order of $14 billion. That may sound impressive, until you consider that is only a small fraction of the resources of any one of our nation's largest banks.

There lies the central question which concerns all of us: what degree of concentration of banking assets, in what geographic patterns and within what structure of federal and state control, is proper and appropriate in the public interest?

It's not a new question. Alexander Hamilton and Thomas Jefferson fought over the creation of the Bank of the United States, our first interstate bank. The excesses of that bank led Andrew Jackson to veto the renewal of its charter. Because of the veto, the bank's supporters mounted a powerful political campaign to unseat Jackson and deny him a second term. They failed, and in 1833, shortly after his reelection, Jackson administered the death blow to the bank by withdrawing the public deposits, saying as he did so, "One of the most serious objections to the bank is the power which it concentrates." From that time on, the policy of the country was set away from concentration and towards dispersal of financial resources.

Geographic restrictions have been largely responsible for the local orientation of the American banking system. Bankers and their customers live in the same communities and know each

other. Credit is granted locally. Crucial decisions affecting the future of individuals and businesses, sometimes of entire communities, are made on the basis of personal knowledge, and not merely on a review of financial statements at bank headquarters in distant cities.

Writing for a unanimous court in last week's decision, Justice Rehnquist noted that the court had stated in the Lewis case that "banking and related financial activities are of profound local concern." He went on to say:

> "This statement is a recognition of the historical fact that our country traditionally has favored widely dispersed control of banking. While many other western nations are dominated by a handful of centralized banks, we have some 15,000 commercial banks attached to a greater or lesser degree to the communities in which they are located."

However, as he also observed, during the 1970's the New England states found themselves faced with growing competition from nonbank financial companies not confined within state lines and they therefore sought an alternative that would allow expansion and growth of local banks without opening their borders to unimpeded interstate banking.

The Hebb Commission established by the Connecticut General Assembly in 1979 to study the problem of interstate banking, concluded in its 1983 report:

> "Both at the national and state levels the philosophy underlying our structure of bank regulation has been to promote a pluralistic banking system - a system comprised of many units, rather than a highly concentrated system made up of a few large banks. The promotion of local ownership and control of banks has as one of its objectives the preservation of a close relationship between those in our communities who need credit and those who provide credit. To allow the control of credit that is essential for the health of our state economy to pass to hands that are not immediately responsive to the interests of Connecticut citizens and businesses would not, we believe, serve our state well. Similarly, to expose our smaller banks to the rigors of unlimited competition from large out-of-state banking organizations - particularly at a time when deregulation of banking products at the federal level is already putting strains on the resources of smaller banks - would not be wise."

The Commission delivered its report in January of 1983 and its recommendations for new regional interstate banking legislation were enacted into law by the Connecticut legislature. Similar legislation had been previously enacted in Massachusetts. These

statutes, which became known as the New England experiment, have now been affirmed by the Supreme Court. The justices were unanimous in their finding that the history of the Douglas amendment indicates the intent of Congress to allow each state flexibility in its approach, and that the Connecticut and Massachusetts laws allowing only regional acquisitions are consistent with the Douglas amendment's and the Bank Holding Company Act's purpose of retaining local, community-based control over banking.

However, I do not appear before you this morning as an advocate of regional interstate banking. Rather, I am here as a proponent of an experiment. The first recommendation of the Hebb Commission, to which I just referred, was as follows:

> "An experiment in interstate banking would be desirable. By 'experiment' we mean a first step toward interstate banking that would allow limited entry by out-of-state banking organizations and would afford the legislature an opportunity to make its own calculus of the benefits and detriments that might result from a broader program of interstate banking."

And that's exactly what we are engaged in. An experiment is by definition, a test - carried out under controlled conditions to confirm a theory or hypothesis and see what its effects may be. It was the conclusion of the Hebb Commission that innovation,

trial and experiment on a regional basis, would be entirely appropriate to the rational and deliberate evolution of interstate banking -- and that's especially true when the potential consequences of legislative action at the Federal level are as sweeping as they are in this instance.

Last Thursday, Secretary Baker appeared before your committee and stated the Administration's support for the concept of full interstate banking. The "New England Experiment" also supports this concept. However, even if the Congress ultimately accepts the Secretary's recommendation, it still leaves unanswered the questions of how do we get there and how fast?

Isn't it really much too early to say? Let's remember that the experiment -- delayed by a two-year legal struggle -- has just begun. In New England, in fact, the experiment began only two days ago. We are a considerable time away from any real assessment of the results. During these coming months, other states in other regions will be embarking on their own experiments.

I suggest that we wait for the results. It hardly seems wise or necessary to prejudge or try to anticipate the outcome of the experiment. Certainly the public is not clamoring for action. There is nothing to be gained -- and much that could be lost -- in considering interstate banking legislation without the benefits of the coming regional experience.

Mr. Chairman, I can only echo your own comment of last week: we see no need for an interstate banking provision in your legislation this year. On the other hand, we recognize that Congress will ultimately determine, after due consideration, whether it's best to continue to leave the structure of banking up to the states or to make it a matter of national law.

We look forward to participating with you in your further studies and deliberations of interstate banking issues. Certainly we will always be ready and willing to share with you the results of our own New England experiment as they develop.

Thank you very much.

The CHAIRMAN. Thank you.

Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman.

Let me first of all welcome the panel and particularly the last speaker, Walter Connolly.

The CHAIRMAN. He wasn't the last speaker. That's the first speaker.

Senator DODD. Well, the last person who spoke. He should be the first. I welcome him to the committee this morning and congratulate him on his new status, if you will, as chairman of the Bank of New England.

I have an opening statement, Mr. Chairman, which I would ask unanimous consent be included in the record at this point.

The CHAIRMAN. Without objection.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. Mr. Chairman, it is with great pleasure that I welcome another outstanding chairman, Walter Connolly, the chairman and CEO of the Bank of New England Corp., the first regional bank in New England after the Supreme Court gave approval to regional banking last week.

It is fitting that Mr. Connolly should be in this position, in that he was born in Boston and then attended Yale University before starting in the insurance and investment business in Hartford. In 1961, he started working for the Connecticut Bank & Trust Co. and then went on to become president in 1970, CEO in 1977, and chairman in 1980. He assumed his latest titles just 2 days ago.

Mr. Connolly also is a good corporate citizen. He is a director of the Institute for Living, an outstanding mental health facility, as well as a regent and trustee of other worthy organizations. He is also a former fund drive chairman of the Greater Hartford United Way and the St. Francis Hospital building fund campaigns.

Before letting Mr. Connolly proceed, I would just like to add that his company is taking some steps to address the concerns about lifeline banking that were addressed by witnesses before this committee last week. As of March, CBT initiated a system that, among other things, permits all bank customers five free checks a month as well as the ability to pay bills by phone. It is this kind of responsiveness that has enabled CBT and now will enable Bank of New England Corp. to be a leader in its field.

And I presume we will have an opportunity to ask some questions at the appropriate time.

The CHAIRMAN. Senator Dixon, do you have any comments?

Senator DIXON. No, Mr. Chairman, but I have an opening statement I would appreciate placing in the record.

The CHAIRMAN. It will be placed in the record.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning at the eighth in our series of hearings on problems facing the financial services industry. We have a distinguished panel of witnesses before us this morning, and I look forward to hearing their testimony.

As everyone here knows, the prime rate fell yesterday to 9½ percent, moving short-term interest rates to as much as 4 percent below last year's levels, and about 1½ percent below their March levels. Long-term rates have also declined to levels about 2½ percent below last year's levels.

I am gratified to see a prime that is finally back to single digit levels. Lower interest rates will be good for many sectors of the financial services industry, particularly the troubled thrifts, and will help improve our overall economic strength and competitiveness. Lower interest rates, however, while extremely helpful, are not a complete answer to the issues facing the Congress in the financial services area. Legislation is still necessary, indeed, it is essential.

I look forward to receiving the expertise and recommendations of this morning's witnesses, and to working with them and all interested parties in fashioning appropriate and reasonable legislation that can be quickly moved through the Congress.

The CHAIRMAN. Mr. Hickman.

STATEMENT OF JOHN W. "BILL" HICKMAN, PRESIDENT, DIXIE STATE BANK, ST. GEORGE, UT; PRESIDENT, WESTERN INDEPENDENT BANKERS

Mr. Chairman, members of the Committee, my name is John W. "Bill" Hickman. I am President of the Dixie State Bank located in St. George, Utah. Our current assets are approximately 40 million dollars and we operate two branch offices. During 1984-85 I have been serving as President of the Western Independent Bankers. WIB is pleased to be asked to testify today alongside these other banking associations.

WIB represents independent, community-oriented banks in thirteen states of the West. These include Alaska, Arizona, California, Hawaii, Idaho, Nevada, Oregon, Utah, Washington. We have a few members in Colorado, Montana, New Mexico and Wyoming. Our association is regional in scope and has been in existence since 1937.

Some 400 commercial banks belong to WIB and through their branches our members are in approximately 1,400 separate locations. Our members' banking experience has been gained over the years by competing directly with giant, state-wide branching institutions; facing a variety of innovative and challenging financial service providers; marketing locally against very dynamic and creative advertising campaigns and now the latest in electronic and state-of-the art banking activities. Yet, WIB members are surviving and, indeed, where the local economy is healthy, they are thriving.

WIB member banks are not afraid of changes in the traditional system.

The states in which the majority of our members are located are ones which are taking active steps to enact operating arrangements that cross over traditional geographic boundaries.

WIB members are frequently state chartered and we have the highest respect and support for the dual banking system that exists in this country. In fact, although we recently modernized our bylaws, we specifically reaffirmed our goal to preserve this dual structure.

Our views on the need for new banking legislation can be expressed briefly:

- o WIB supports the closure of the non-bank bank loophole with the most restrictive grandfathering politically possible
- o WIB urges the greatest possible expansion of permissible bank services to better equalize competition among the financial service institutions
- o WIB strongly urges that the dual banking system be fostered and that no Federal "trigger" to interstate banking be established at this time

To elaborate somewhat on these points, let me say that WIB members have a unique perspective on these matters -- we have already lived under some of the conditions that are now being discussed as if they were new. In our Western states the arguments against state-wide branch banking and the dire predictions of the demise of independent community banks surviving have already taken place. Years of experience have demonstrated that the service-oriented, locally managed and owned bank is a truly viable and essential ingredient in

local communities and suburbs, as well as, an effective provider of services in the most highly urbanized and populous cities. In truth, the bigger the opposition, the better we are able to serve the individual customer with one-on one attention.

Our success in this matter has spawned a number of advertising campaigns and tactical plans by large institutions to copy the traits exemplified by our banks.

Many of the strongest criticisms of the banking industry which are now being stated as examples of industry abuses, such as the "inability" to cope with present powers or a lack of sympathy for customers' needs are the result of problems with larger institutions.

Much of the criticism of the banking system involving systemic problems of electronic funds transfer overdrafts, international loans and overextensions of credit in the energy area, sufficiency of the deposit insurance coverage and the consumer issues of funds availability and "subsidized accounts" are clearly the result of conditions not generated by our banks.

Our message to this Committee and equally to our counterpart independent community bankers in other places in this country, is to look to our experience to clear away some of those concerns which stem principally from the fear of the unknown.

To those critics who state that the industry is not able to handle its current powers and that new powers are beyond the capability of banks to carry out responsibly, we urge the Committee to look at the innovations made under state laws such as California in real estate investment powers and other areas and to note that our community banks are certainly capable of utilizing this type of activity.

We would note that some states have granted these powers to banks directly without the requirement of the formation of a separate holding company structure. We support this approach and urge that nothing be done at the Federal level to impede the operation of these laws and regulations and that Federal rules, regulations and legislation take the same approach.

Smaller banks like ours did not originally ask to get involved in these newer areas of operations. It has been the incursion into the banking industry's province that has created the need for equalization of the powers available to banks. To compete with other industries which are using the image of a bank, but who can operate without similar constraints, our small banks must be able to select new services that they can do well locally and which their service area needs. Limiting banks while giving other institutions a "go ahead" simply creates an imbalance that threatens the safety and soundness of the industry.

To permit a non-bank bank to skirt laws and regulatory compliance that is operative upon our members' banks is not healthy for the system. To permit institutions that are not covered by a uniform deposit insurance system and subject to the same demanding regulatory and supervisory conditions is equally dangerous. When institutions hold themselves out as "banks" they should have to meet "bank" standards.

WIB supported S. 2181 in the last Congress. We did so not because it represented all that we wanted, nor was in totally satisfactory.

We are, however, practical and realistic. We know the legislative progress requires compromise and flexibility Our support or opposition for any legislation will be measured by an overall review of the "pluses and minuses" weighed against the possibility for enactment.

We would support passage of a bill similar to S. 2181. Now that the Supreme Court of the United States has handed down its opinion in the Northeast Bancorp Inc. case, WIB does not feel that Congressional action recognizing the right of states to develop limited interstate banking opportunities is required. We believe that this places the responsibility where it best can be carried out and that the states will move forward towards full interstate banking as conditions and market forces dictate.

Thank you for this opportunity to comment on some of the issues facing the independent community type banker in the West.

The CHAIRMAN. Thank you, Mr. Hickman. I also want you to realize that this is not normal District of Columbia weather. You just appreciate that dry air in St. George and we'll be back to normal here in Washington with heavy humidity soon and then you will really appreciate where you live.

Mr. Stallkamp.

STATEMENT OF WILLIAM J. STALLKAMP, SENIOR VICE PRESIDENT, MELLON BANK, PITTSBURGH, PA, MEMBER, BOARD OF DIRECTORS, CONSUMER BANKERS ASSOCIATION

Mr. STALLKAMP. Mr. Chairman, I am William J. Stallkamp, senior vice president of Mellon Bank in Pittsburgh. I am a member of the board of directors of the Consumer Bankers Association [CBA], on whose behalf I appear today.

At the outset, Mr. Chairman, the CBA would like to commend you and the members of your committee for your diligent efforts to modernize our financial institutions' laws. Our association realizes the difficulty involved in passing comprehensive legislation and we are pleased to have the opportunity to give our views today.

We also commend you on successfully drafting and passing the Financial Services Competitive Equity Act, S. 2851. The CBA supported many of the provisions of that legislation. Your bill was a progressive step toward matching our financial institutions' legal requirements to today's marketplace.

THE NEED FOR LEGISLATION

Although the House of Representatives was unable to pass a bill last session, this does not indicate that the need for comprehensive legislation has diminished. To the contrary, the need is even greater today. Today's consumers demand more varied, convenient, and efficient financial services that satisfy their increasing needs.

Yet traditional financial institutions—banks, savings and loans, credit unions, mutual savings banks—must operate within a legal framework established 50 years ago.

One of the more important rationales for the Federal regulation of financial institutions is to ensure the safety and soundness of the banking system. The CBA believes this to be of paramount importance in the current discussion of financial deregulation. The risks to safety and soundness have been misconstrued, however, and some of the ills of the financial system have been attributed to deregulation which has only occurred on the liability side.

Few new banking products or services have been authorized. To believe otherwise is a misperception.

Comprehensive deregulation will enhance the safety and soundness of depository institutions. A key component of sound corporate management and stability is diversification.

Diversification of both products and geographic base would provide consumers with a wider choice of financial services. It would also provide institutions with a wider base of profitability, making them stronger and making the system more sound.

And what of the risk in these new diversified services?

While we support a wide range of new powers and open competition, many of the contentious issues before the committee involve

the least amount of risk. For example, there is no risk to the institution selling insurance, other than in the event that no one buys it.

The same is true of securities brokerage. The bank takes no position in the securities, and therefore takes no risk.

We believe a number of other powers are proper for banks and thrifts, but we use these two as dramatic examples that deregulation and soundness are compatible. Deregulation and diversification simply are not synonymous with greater risk. An obvious reason for opposition to these modest powers is the protection of those already offering such products.

INSURANCE

I'd like to move on to insurance. One of the major areas of the financial services market barred to banks and bank-holding companies is the general business of insurance. At the same time, leading insurance companies have for some time been positioning themselves to meet customers' demands for comprehensive financial services. Insurance companies, securities firms, retailers, and others are now leveraging existing customer relationships by expanding into related financial services and cross-selling their products and services.

In the dispute between the insurance and banking industries over the financial services market, consumers' needs and wishes have been virtually ignored. Yet numerous surveys and actual market experience provide substantial evidence that the public would welcome the opportunity of obtaining insurance from their banks.

For example, a recent survey of consumers by the life insurance industry found that 59 percent of the respondents believed that banks would do a good job of providing one-stop financial services, including insurance, compared to only 16 percent for life insurance companies. Consumers rated banks highest in terms of quality of service, respect for individual privacy, treatment of people as individuals and giving people their money's worth.

Our written testimony provides a number of other survey results, showing that consumers would like additional sources for obtaining insurance products.

With regard to the provision of S. 2851 which restricted the insurance activities of bank-holding company subsidiaries and affiliates, we ask the committee to reconsider its position. The Garn-St Germain Act does not preempt the right of individual States to regulate insurance. It also provides a number of exceptions to the prohibitions on insurance activities of bank-holding company subsidiaries.

Therefore, we support the view that Congress did not intend to prohibit all affiliations between banks and insurance companies.

Legislation as was passed last year is not in the best interest of consumers, since it denies them the opportunity to obtain insurance at a lower cost, and more conveniently. In addition, there have been no persuasive arguments that tying arrangements will occur.

SECURITIES PRODUCTS

In the securities area, CBA strongly supports the expansion of securities activities for depository institutions.

The Glass-Steagall Act never established an absolute barrier between securities and banking activities. It did permit banks to engage in various securities activities, such as underwriting municipal general obligation bonds and purchasing and selling securities for the account of bank customers.

Conditions have changed dramatically during the 50 years since Glass-Steagall was enacted.

A statutorily imposed, artificial wall between securities and banking activities is no longer tenable or desirable in today's business and economic environment.

CBA believes that the task before this committee and the Congress is to allow depository institutions to engage in the underwriting of municipal revenue bonds, including industrial development bonds. Portions of this proposal have been before Congress many times and have, in fact, been passed by the Senate as recently as last fall. Also, at a minimum, such reform should allow depositories to operate and underwrite mutual funds, which would benefit small businesses and the consumer. Trust departments have operated mutual funds for years in the form of common funds.

OTHER RETAIL ISSUES

There are some other retail issues I would like to address. This committee has considered legislation to authorize bank-holding companies to engage in activities of a financial nature. We therefore recommend the inclusion of such an initiative in this year's committee deliberations.

We would also ask that the committee again include legislation clarifying the authority of national banks to engage in leasing and ask that you reconsider revisions to the Consumer Leasing Act this session as you did in the 98th Congress.

Further, there are now more than 100 shared automated teller machine systems in the United States. Customers have access to their funds anywhere the system operates. Eight systems operate nationwide. National banks and others have invested over $1 billion in shared ATM networks and now customers of many entities can access them. For example, holders of American Express cards can participate in the CashStream ATM system operated by Mellon Bank and others.

The courts have ruled that these shared ATM's are not branches. Any legislation which addresses the issue should make clear that they are not branches and are not limited by interstate branching restrictions. This is a matter of consumer demand.

GEOGRAPHY

Moving on to geography, Mr. Chairman, you and other members of the committee have indicated that your preference is to defer a decision on interstate banking.

We respect your concerns, but we have developed a transitional approach to interstate banking which appears in our written testimony.

With your permission, I would like to briefly review our position. First, the marketplace already provides most financial products on an interstate basis. Artificial restrictions on banking activities are inefficient and outmoded.

Second, there are several ways in which to make the transition—regional compacts with triggers; cross industry acquisitions; expanded toehold opportunities; parity with thrifts on branching, and electronic terminal deployment.

Third, our preference is regional compacts mandated to lead to full interstate banking.

And, fourth, concerning the nonbank bank, we cannot in good conscience support changing the definition of a bank unless there is concurrent deregulation of geographic and product restraints. We urge that the committee adopt a broad-based bill which addresses overall modernization and competitive equality, rather than a narrow loophole closer.

CONCLUSION

The CBA is very appreciative of the effort you have put forth, Mr. Chairman, and we will provide you and your staff with any additional information.

We are not opposed to others entering our business. Competition will be good for us and for our customers. We only ask that it be a two-way street and that we be allowed to compete fairly and on the basis of parity.

Thank you.

[The complete prepared statement follows:]

TESTIMONY OF

THE CONSUMER BANKERS ASSOCIATION

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

PRESENTED BY

WILLIAM J. STALLKAMP

JUNE 19, 1985

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Mr. Chairman, I am William J. Stallkamp, Senior Vice President of Mellon Bank, N.A., in Pittsburgh, Pennsylvania. I am a member of the Board of Directors of the Consumer Bankers Association (CBA) /1 on whose behalf I appear today.

At the outset, Mr. Chairman, CBA would like to commend you and the members of your Committee for your diligent efforts to modernize our financial institutions' laws. Our Association realizes the difficulty involved in passing this comprehensive legislation, and we are pleased to have the opportunity to give our views today.

We also commend you on successfully drafting and passing The Financial Services Competitive Equity Act, S.2851, since CBA last testified here. As indicated in that testimony, we supported many of the provisions of that legislation. We would have preferred that several

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1/ The Association is a nonprofit organization that was organized in 1919 to provide a voice for the retail banking industry. Today, membership in the Association is open to any federally insured depository institution, including commercial banks, thrifts, and credit unions. Associate members include bank card processors and service provider organizations. Combined, the members of the Association now hold over 70% of all consumer credit outstanding held by commercial banks and over 80% of the consumer deposit accounts held by commercial banks.

additional provisions were included, notably a "trigger" to move regional banking compacts into full interstate banking. But your bill was a progressive step toward synchronizing our financial institutions' legal guidelines with today's marketplace.

THE NEED FOR LEGISLATION

Although the House of Representatives was unable to pass a bill last session, this does not indicate that the need for comprehensive legislation has diminished. To the contrary, it is greater than ever. The market continues to evolve to meet the challenges of consumer demand, technology, rapid information flow, convenience, efficiency, and coordinated investment and transaction plans for individuals. Yet traditional financial institutions - - banks, savings and loans, credit unions, mutual savings banks - - must operate within a legal framework established 50 years ago.

Our testimony will focus on that portion of the industry which is dedicated to providing the widest possible array of financial services to consumers. Certain issues will be familiar to members of this Committee and will be raised only where the impact of recent events has influenced them, or because they continue to reflect premises basic to an understanding of CBA policies.

The dominant CBA premise is that the governing principle for regulating financial markets should be to assure parity of treatment among all providers of consumer financial services. Only by using this principle as a touchstone for legislative action will it be possible to move from the current industry structure - artificially and inequitably fragmented by product and geographic restrictions - to one that encourages the most efficient and economical availability of the financial services now sought by consumers.

As adopted by CBA's Board of Directors, this Association's charge is to seek:

> "parity among all providers of consumer financial products and services, in which such vendors shall receive competitive equality and be subject to the same regulations and statutes so that no competitive advantage or disadvantage exists among them."

Indeed, believing that an equality of opportunity should be accorded to consumer financial service providers of all types, the CBA was one of the first and continues to be one of the few financial trade associations to open its membership to all federally insured providers of consumer financial services. Today, that membership includes not only commercial banks but also savings and loan associations, mutual savings banks, credit unions and federal savings banks.

This recognition of a common denominator in consumer financial services underscores the CBA's unequivocal commitment to a new financial order based on competitive equality. There is no room within this prescription to exclude competitors from entering what historically have been areas left exclusively to traditional depository institutions. On the contrary, we welcome, without exception, all participants who are prepared to compete on an equal footing because we believe that this will contribute to a strong and vital financial services industry.

This industry will thrive, however, only if the marketplace is free of historical and structural distinctions that presently inhibit fair and efficient operations by allowing nondepository institution service providers significant competitive advantages.

We believe it is time to authorize commercial banks and other federally insured depository institutions to provide, on an unlimited geographical basis, the kinds of securities and insurance products and other services offered by their competitors.

The obsolescence of the present system of product and geographic constraints is best demonstrated by the numerous exceptions and artifices used to circumvent

these impediments. Further proof that these limits are obsolete lies in the recent activities of many states to broaden the scope of permissible bank activities and to permit interstate bank acquisition.

To address effectively the dramatic shifts and inequities in the marketplace and the anachronistic restrictions that promise only to perpetuate and enlarge the competitive disadvantages of federally regulated depository institutions, the legislative process must evince a boldness and innovation which have been lacking in previous legislative debates on these topics.

In the past, the industry and Congress have approached the legislative task in the now-familiar pattern of intra-industry squabbles, tinkering with existing constraints, juggling the interests of an increasingly diverse community of service providers, and formulating policy on the basis of judgements as to the relative pluses and minuses among affected industry segments, rather than by attempting to fashion a financial system that follows substance.

CBA believes strongly that neither the financial industry nor the consumers they serve can abide this legislative approach any longer. Instead, we would ask that the following concepts guide your deliberations.

First and foremost, as discussed earlier, the guiding principle must be parity -- not just parity when pursuing a particular goal that means that "we" obtain an advantage over "them," but parity that means equal treatment, whomever that may effect on a particular issue.

Second, product, service, and geographic limitations affecting both depository and nondepository institutions should be ended. Activities supported by proven market forces should be encouraged. The entire array of financial service products should be available to all types of providers whenever they believe it is efficient to offer them.

Third, regulatory involvement should be carefully limited to policing the very narrow range of financial activity that affects the deposit function, imposes a danger for the safety and soundness of the banking system, or has a demonstrable impact on monetary policy. This would enable the market to shape the industry with a minimum of protectionist regulatory interference.

Fourth, there should be a revitalization of efforts to identify the appropriate information to be disclosed to the public, information that does not confuse, but rather informs.

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Obviously, these are only some of the major principles that must be taken into account. As these principles are identified, however, it is important to recognize that they must be founded on social and economic efficiencies, and should be imposed by statutes and regulations unnecessarily burdensome to the American financial experience.

In addition to these efforts at the federal level, Congress should protect and encourage the efforts of the several states that have recognized the realities of the new diversification in the financial services arena. These initiatives range from the abolition of archaic interest rate ceilings to the reconsideration of appropriate services on the part of state banks. These laudable efforts have illustrated a new realism and a thrust toward parity that is long overdue.

We strongly believe that a rapid recognition of and adjustment to the new financial environment will free economic forces to engage in productive endeavors. This will be a major step forward in providing reasonably priced and widely available consumer financial services.

GEOGRAPHY

The issue of geographic expansion has been one of the most controversial banking topics under consideration by the Congress.

Considering last week's decision in the Supreme Court, which affirmed the right of the states to enter regional banking arrangements under the Douglas Amendment, and the actions of the House Banking Committee, which reported legislation to sanction regional banking as an interim step to full interstate banking, todays hearing is extremely timely.

We are committed to the principle of geographic deregulation and would accept regional compacts as a necessary interim measure. We would urge that any banking legislation on the subject include a so-called "trigger" for interstate banking.

Such legislation would not contradict the Supreme Court ruling. The Court merely interpreted present law. It did not address the needs of the marketplace.

The statutory structure that governs commercial bank operations must be conformed to market realities. In the long run, this means that all geographic barriers

restricting depository institutions must be removed. That is the only way to assure consumers a full range of competitively priced products and services, to assure fairness among all financial service providers, and to permit delivery approaches and systems that are shaped by competitive market forces rather than by artificial government fiat.

Congress must begin to consider elimination of geographic barriers by providing a specific timetable for the phase-out of all such restrictions. An efficient and orderly transition from a regulated to a market-oriented environment calls for legislation setting forth a transitional scheme and containing a specific date for total and complete deregulation. A number of interim steps in addition to triggered regional compacts might be viable transitional options, including:

- o Authorization of cross-industry acquisitions. CBA supports cross-industry acquisitions, but believes that additional geographic and service restrictions over and above those that currently apply to holding companies and their subsidiary depository institutions should not be imposed.

- o Parity with thrift institutions. CBA believes that commercial banks should be authorized to branch to the same extent as thrift institutions.

- o Expanded "toehold" opportunities. CBA supports an increase in the percentage of voting stock in a bank that a bank holding company may acquire without triggering the

geographical restrictions of the Douglas Amendment.

o Electronic terminal deployment. CBA believes that unlimited deployment of automated teller machines (ATMs) and other electronic terminals should be authorized for all commercial banks. This would do nothing more than recognize what is occurring in the marketplace and provide parity with thrifts and other deployers of ATMs.

In support of these positions, we would refer the Committee to the detailed review of these options contained in our testimony of February 22, 1984.

Rationale For The Removal Of ALL Geographical Barriers

Geographical restrictions on depository institutions are obsolete, they limit the number and types of financial products available to consumers, and they frustrate the attainment of parity since other financial service competitors are not similarly constrained. Economic, social, and demographic factors have changed dramatically since current branching restrictions were enacted in 1927 and restrictions were imposed on bank holding companies in 1956.

While other financial service providers and depository institutions are not constrained by the same geographic barriers that apply to the commercial bank system, commercial banks have found various approaches

and mechanisms to respond to the needs of a changed marketplace. These devices have evolved irrespective of the geographic barriers imposed by the McFadden Act and the Douglas Amendment.

Many banks and bank holding companies are performing banking and banking-related activities on an interstate basis. Those activities include consumer loan and leasing operations, import/export financing, and general commercial lending activities. Emerging technologies allow banks to provide financial services on an interstate basis through shared electronic systems and other mechanisms, such as retail credit card operations, loan production offices, and Edge Act corporations.

It is important to emphasize that these interstate financial services are being provided through totally legal channels. These devices are legal by virtue of validating court decisions and, often, specific actions of Congress. For example, the 1970 Bank Holding Company Act amendments authorize bank holding companies to engage in activities that are "closely related to banking" on an interstate basis. Under that authority, bank holding companies operate industrial banks, mortgage companies, and finance companies and provide leasing, factoring, and a vast array of other financial services without regard to artificial geographic boundaries.

However: The Douglas Amendment and the McFadden Act preclude commercial banks from providing these same services directly, on an integrated basis, nationwide. Accordingly, through a complex system of legal maneuvering, service compartmentalization, and multi-entity gamesmanship, commercial banks with adequate resources are able to surmount legally the supposedly inviolate walls of McFadden/Douglas.

Avoidance of those barriers has several adverse impacts. First, not all bank entities have the resources to engage in these activities, thus limiting the field of competitors. Second, each of these devices produces costs that serve no sound social or economic end. Finally, the combination of added costs and fragmented service produces needless inefficiencies that prevent consumers from using these products and services without paying a "government regulatory" surcharge. While banks and bank holding companies must utilize one or a number of these alternative devices for providing interstate services, quite clearly the direct provision of those same services by the bank itself would be more efficient. Geographic constraints on commercial bank operations, therefore, merely serve to foreclose alternative options that are more desirable and more

efficient avenues for the nationwide delivery of financial services.

While the federal government has been extremely reluctant to address interstate banking issues, states have been taking the lead. At present, two-thirds of the states have enacted or are considering some form of interstate banking legislation. In virtually all instances, however, state action has imposed conditions and limitations that do not permit true interstate banking.

Although in some substantive areas state action is appropriate and provides an instructive experimental forum, in the case of geographic restrictions state action only produces a new system that is innately fragmented by the ad hoc decisions of the respective legislatures. Instead of limiting the provision of banking services by depository institutions along artificial state lines, many of these state enactments merely establish new artificial regional boundaries. The Supreme Court ruling in Northeast Bancorp will only encourage further balkanization of this sort.

In our truly national economy with its national banking system, in which money flows without regard to artificial political boundaries, regional restrictions

raise the same problems as state restrictions. Therefore, while state actions have served to highlight the obsolescence of geographic limitations on bank operations, state enactments are not an appropriate long-range answer to the market dislocations that result from those restrictions.

Concentration

Historically, opponents of interstate banking have argued that it would lead to a concentration of economic power. We believe that this is a false argument. In fact, it seems reasonable to assume that existing restrictions on interstate activities encourage pockets of monopolies or near monopolies.

First, concentration in and of itself is not objectionable. It is only when that concentration becomes anticompetitive -- a result against which a full panoply of antitrust rules guards -- does concentration become troublesome.

Second, concentration is a concept that has economic meaning only when it is applied to a particular market. The market is considered to be highly concentrated when it is divided among relatively few firms and to be unconcentrated when it is shared by many firms. In order

to have any economic meaning, therefore, the term "undue concentration" must first refer to a market in which there are very few competitors.

Since the traditional and primary function of commercial banks is to provide deposit and loan services, the "relevant market" is the market that provides those services. That market includes savings and loans, savings banks, credit unions, and even brokerage firms, as well as finance companies, retailers, factors, and other enterprises that make loans to consumers and commercial enterprises. Thus, to determine if the elimination of geographical barriers will present risks of undue concentration, one must determine whether that market is concentrated now to any significant degree such that the elimination of barriers could create the prospect of "undue concentration."

The market for loan and depository services is highly unconcentrated. The number of depository institutions alone is in the range of between 35,000 and 40,000 separate institutions. When other providers of similar services, such as brokerage firms, are factored in, the number is much greater and is increasing all the time.

It is obvious that the existing financial services industry does not even border on being "concentrated"

and, therefore, the elimination of geographic barriers as both a practical and a legal matter cannot be said to invoke the spectre of "undue concentration." In fact, just the contrary is true. The elimination of geographic barriers should promote competition and enhance the services that are provided to the public.

Other concerns, that the elimination of geographic barriers will signal the end of community banks, thereby lowering the level of service to certain locales, and will jeopardize the dual banking system, also are not borne out by historical experience or logic.

Community banks enjoy a number of advantages in terms of established customer relationships and loyalty, convenient location, and knowledge of the local market. These community banks should continue to thrive in a deregulated environment. Experience confirms this in states with unrestricted branching laws, where community banks have prospered.

Finally, the elimination of the Douglas Amendment would have no effect on the dual banking system since holding companies would continue to have the option of owning state chartered banks, national banks, or both. Also, the removal of branching restrictions that apply to national banks should not have a detrimental effect.

Experience indicates that states normally act to provide the same advantages to state chartered institutions as are provided by the federal government to federally chartered institutions. There is no reason that this precedent should be any different in the case of interstate branching. In fact, it is just the reverse, since a number of states have already taken action to eliminate interstate barriers.

CBA's Position

Recognizing that any transitional measures will have an uneven and inefficient impact on the financial services industry and the consumers it serves, we believe that any transitional measures should be short in duration. Of paramount importance, however, is that any legislation that establishes transitional measures must also provide for the ultimate, timely elimination of all geographic barriers.

Redefinition of a Bank

The non-bank bank issue is inextricably entwined with any overall consideration of geographic and product deregulation.

As outlined in this testimony, such deregulation is crucial to providing parity and competitive equality among banks, other depository institutions, and commercial concerns which are engaging in financial services. In addition, it would provide benefits to consumers across the country.

Various legislative proposals before Congress now and during the last session have sought to redefine the term "bank" for purposes of the Bank Holding Company Act, thereby regulating these new, special purpose banking institutions. The Committee is thoroughly familiar with the so-called loophole in defining a bank, and no elaboration is needed. CBA's testimony of February 22, 1984 can be cited for additional information.

The recommendations in that testimony set forth several specific avenues through which to work geographic deregulation. CBA is committed to this goal as an essential part of any banking reform law.

Therefore, no redefinition of the term bank is appropriate in our view unless and until other action is taken <u>simultaneously</u> to begin the process of geographic and product deregulation.

ELECTRONIC FUNDS TRANSFER CAPABILITIES

During the past two years, CBA has testified before this Committee and asked that you consider authorizing the nationwide deployment of electronic funds transfer terminals for commercial financial institutions. Technological advances of electronic funds transfer capabilities and market place developments underscore the need and our continued support for this position.

The automated teller machine (ATM) is the most widely known and used electronic funds transfer device. ATMs permit a customer of a financial institution to communicate with that institution for the purpose of performing one or more types of financial transactions, including withdrawals from asset accounts, transfers between accounts, balance inquiries, deposits, and cash advances on established lines of credit.

The first ATM appeared in the United States in 1969, and approximately 2,900 ATMs were operating by the end of 1974; this number quadrupled to 12,000 ATMs by 1979; and tripled again, to 38,600 operational ATMs by the end of 1983; 55,000 ATMs were in use as of June, 1984. Not only has the number of these devices multiplied, but so has the use of each machine. A 1979 survey reported that the average ATM monthly transaction volume, excluding balance

inquiries, was approximately 3,500 transactions, while a more recent survey showed an average volume of 4,730 transactions per month.

It has been estimated that there were 2.2 billion ATM transactions in the United States during 1983; those transactions included cash withdrawals in excess of $150 billion. These figures evidence the growing volume of ATM transactions, especially during the last five years. They also underscore the public acceptance of, and reliance upon, the convenient services that ATMs provide.

Customer convenience is one of the major reasons for the growth of electronic banking services. A decade or so ago consumers were often limited to transacting their banking business at fixed bank locations during regular and often limited banking hours. There were relatively few means for consumers to access their bank accounts at off-hours, while at work, or at any distance from home, except perhaps through checks and bank credit cards. Vacationers were often forced to carry large sums of money or traveler's checks to ensure that their cash needs could be met. On extended trips, consumers had to make complicated arrangements to ensure that their bills at home were paid. The development of automated access systems has changed the delivery of financial services and now enables consumers to transact their banking business much more conveniently.

The many geographical inequities and anomalies in the financial services marketplace are most evident in the electronic funds transfer area. The branching provisions of the McFadden Act restrict the deployment of ATMs for national banks. However, all federally-chartered thrift institutions and credit unions, all non-depository institutions (including large nationwide companies such as Safeway and Publix supermarkets, the retail firm of Sears, Roebuck & Co., and the brokerage firm of Merrill Lynch Pierce Fenner & Smith, Inc.) and many state-chartered depository institutions are not subject to any restrictions on their ownership of ATMs, their geographic deployment, or the ability to participate in shared ATM networks. /2

CBA seeks parity on this issue and it is scarcely alone. The Consumers Union has also testified before

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2/ See Federal Home Loan Bank Board Remote Service Unit Regulations, 12 C.F.R. Section 545.141(a) (3): RSUs which include ATMs, are not branches. See also D. Baker & R. Brandel, The Law of Electronic Fund Transfers, (1984 cum. supp) Paragraph 22.01(2) p.S22-10 (twenty-four states have passed legislation which consider EFT terminals not to be "branches.")

In June, 1984, Merrill Lynch "began allowing clients access to their Cash Management Accounts through automated teller machines in 76 Safeway supermarkets in the Los Angeles area. Merrill Lynch said this is the first step toward allowing holders of these investment accounts to have access to such machines anywhere in the nation." Los Angeles Times, June 18, 1984, at Part IV, p.2, col. 5.

this Committee in support of national banks unrestricted deployment of proprietary ATMs (an ATM owned or rented by an institution). They stated that:

> ...consumers will best be served by a federal law that explicitly allows national banks to establish ATMs without geographic, functional or ownership limitations and without regard to the same type of limitation imposed by the individual states. (emphasis added) /3

At this point, however, we would like to focus on the much narrower issue of shared electronic funds transfer (EFT) systems, especially ATM networks.

We are limiting our discussion to ATMs because they are the most widely used consumer electronic banking device. They are only one type of electronic terminal, however, another is a Point of Sale (POS) /4 terminal which is becoming more prevalent and may ultimately be

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3/ S.2898, The Banking Convenience Act of 1984: Hearings before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 98th Cong. 2d Sess. (September 20, 1984), at 283.

4/ POS system terminals are located in places where goods and services are sold. The terminal permits a customer to pay for goods and services at the retail establishment, by use of an access device and identification code, by electronically debiting the customer's asset or credit account, while at the same time crediting the retail establishment's asset account.

the most widely used. We mention POS because some argue that POS terminals are subject to the same legal restrictions that apply to ATMs. POS terminals should also be avaiable to bank customers on a nationwide basis. We are equallly concerned with any restrictions that might apply to them.

Shared ATM Systems

The past five years have witnessed an unprecedented growth in shared ATM arrangements. National banks and others have invested over one billion dollars to participate in shared ATM networks. This is not surprising, since such shared systems provide the most economical and efficient means for both small and large institutions to provide a broad array of consumer financial services. As of March, 1985, more than one hundred shared ATM networks were in existence, eight of them operating nationwide. /5

A shared ATM arrangement, commonly referred to as a shared network, interchange, or system, allows a number of institutions to conduct transactions with their customers through a common network of ATMs and

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5/ The eight nationwide shared systems are: Plus Systems, Inc., Cirrus Systems, Inc., Nationet, Inc., MasterTeller, The Exchange, VISA, Citishare and Express Cash.

communication link-ups. As a result, the customers of all of the participating institutions may access their accounts by using ATMs owned or leased by other institutions. It is now possible for a vacationer or business traveler with accounts in a Connecticut institution to withdraw cash from an asset account or obtain a credit card advance while in California, through an ATM maintained by a California institution that participates in the same "shared" network as the customer's home institution.

Shared ATM networks have proven particularly valuable to people living in metropolitan areas that cross state lines. For example, an individual who lives in Maryland or Virginia, works in the District of Columbia, and regularly travels and shops around the local area, now has access to his or her savings and checking accounts while at work, at home, or at play, through the use of shared ATM networks. Consumers also find these systems safer than carrying large amounts of cash. The volume of ATM transactions nationwide demonstrates that consumers desire the convenience, cost savings, security and efficiency of such services.

The shared ATM network, like the ATM itself, represents a quantum leap in the ability of institutions to satisfy customer needs.

National Banks and Shared Networks

Widespread national bank involvement with ATMs and shared ATM networks has been based, in significant part, on interpretive rulings and a regulation of the Comptroller of the Currency concerning the application of the McFadden Act's branching restrictions. In November, 1976, the Comptroller issued an interpretive ruling that specified when an ATM would be considered a national bank "branch" under the McFadden Act. This ruling closely reflected a D.C. Circuit decision (Smith) on the issue and provided that any ATM "which is not established by a national bank (i.e., owned or rented by the bank) is not a branch of a national bank and not subject to the provisions of the McFadden Act." /6

On the basis of the 1976 interpretive ruling, the Comptroller's legal staff issued a series of letters all concluding that reciprocal arrangements do not constitute branch banking when institutions allow their customers to make withdrawals and deposits at ATMs owned and operated by other participating depository institutions. In 1980, the Comptroller's Chief Counsel confirmed that national

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6/ Independent Bankers Ass'n of America v. Smith, 534 F.2d 921 (D.C. Cir. 1976), cert. denied, 429 U.S. 862 (1976).

banks could participate in shared ATM networks which operated across state lines, so long as the requirements set forth in the Smith decision were satisfied.

Finally, the Comptroller adopted a regulation codifying the 1976 ruling that an ATM is not a branch of a national bank if the bank does not own or rent the ATM. /7

Consequently a national bank's ATM is not a branch, so long as it is not owned or rented by that bank. In reliance on the Smith decision and the Comptroller's ruling and interpretive letters, national banks and others have invested in shared ATM networks which they had every reason to believe were lawful under the McFadden Act.

7/ The regulation is presently codified at 12 C.F.R. 5.31(b) (1984) and defines a customer-bank communication terminal branch ("CBCT branch") as :

...an automated device, established (i.e., owned or rented) by a national bank at a location separate from the main office of a domestic branch, that:

(1) Takes deposits, or
(2) Disburses cash drawn against:

(i) A customer's deposit account, or
(ii) A customer's preapproved loan account.

The Marine Midland Case

The United States Court of Appeals for the Second Circuit recently affirmed the long standing principle that a shared ATM is not a branch, decided nearly ten years ago, by the United States Court of Appeals for the Tenth Circuit in the Smith opinion and the Comptroller's regulation. In the Independent Bankers Association of New York State, Inc. v. Marine Midland Bank, N.A. et al (Marine Midland), the Court of Appeals held that a shared ATM that was owned by a supermarket but used by customers of Marine Midland, (a national bank) was not a branch of a national bank under the McFadden Act.

The lower court decision had jeopardized the viability of the regional and national systems to the extent that Senators Paul Trible (R.VA) and Gordon Humphrey (R.NH) introduced S.2898, The Banking Convenience Act of 1984. Hearings were held before this Committee on September 19 and 20, 1984. Almost every witness testified in support of the legislation that would have codified the Comptroller's regulation. /8

8/ The following testified in support of S.2898: Consumer Bankers Association; American Bankers Association; Electronic Funds Transfer Association; Consumers Union; Office of the Comptroller of the Currency; Federal Home Loan Bank Board; National Credit
(Footnote Continued)

CBA members were pleased with the action of the United States Circuit Court of Appeals. Though S.2898 would have clarified the issue on a national level, the immediate problems caused by the original Marine Midland decision were alleviated by its reversal. However, a number of events have occurred since that decision which merit continued attention. First, the Independent Bankers Association of New York State is filing a petition or writ for certiorari in the United States Supreme Court. Second, there is litigation pending in Texas on issues similar to the ones raised in the lower court Marine Midland case. Third, bills have recently been introduced in both Houses of Congress including S.1148, The Electronic Banking Equality Act of 1985, offered by Senator Proxmire (D.WI), that would restrict or reverse the Court of Appeals decision.

Senators Trible and Humphrey have also re-introduced legislation this year. S.206, The Banking Convenience Act of 1985, is almost identical to S.2898. It amends the McFadden Act to exempt a shared ATM from the definition of a branch. The only difference between the bills is that the phrase "or similar state law" was

(Footnote Continued)
Union Administration; Food Marketing Institute; U.S. League of Savings Institutions; MASTERCARD International, Inc., and VISA.

deleted in S.206 because it was interpreted by some to preempt state law that prohibited deposit taking at shared ATMs. As it was not the legislative intent, the phrase is not in S.206.

S.206 : The Banking Convenience Act of 1985

The bill amends the McFadden Act to add a new section 12 U.S.C. 36(i) and provides that:

> Notwithstanding any other provision of this section, a national bank may share or permit its customers to use an automated device that is not established by that bank, and such automated device shall not be considered a branch of that bank within the meaning of subsection (f) of this section.

The effect is to clarify that an ATM which is not "established" but that is "shared" is not a branch for the purpose of 12 U.S.C. 36(f).

The Amendment also provides that:

> (A) an automated device is established by a national bank only if it is owned or rented by the bank; (emphasis added).

The legislation thus affirms the Comptroller's regulation and interpretations and the Second Circuit decision. The provision recognizes that there are different types of legitimate financial arrangements in shared systems. For example, there are many national and state member

banks that want to offer their customers access to shared systems but do not have the resources to provide them independently. This section would permit those institutions to participate provided that they did not, in fact, own or rent the ATM.

Concern has been expressed that "owned or rented" could be interpreted liberally by the Comptroller. We submit that there is ample jurisprudence in federal and state law as to the reasonable and proper interpretation of those phrases.

We emphasize that this legislation's sole purpose is to affirm that national banks and state member banks may continue to participate in shared systems only. It does not expand the ability of national banks to deploy proprietary ATMs.

The bill further states:

> (B) an automated device is not established by a national bank if the bank is assessed transactional fees or similar charges for its use.

This clarifies that transaction fees or similar charges are acceptable forms of compensation that may properly be arranged in shared systems, and that such forms of compensation are not an indication that a lease arrangement exists. In conjunction with the earlier language, this would permit institutions to enter into arrangements

that are tailored to meet their respective needs and the demands of their customers. It does not, in our opinion, either encourage, or provide protection for, a "sham" arrangement, in which an institution, in effect, provides a proprietary or wholly owned system to customers in the guise of a shared system. A recent ruling by the Comptroller clearly demonstrates that he will act to prevent any such "shams." /9

9/ The Comptroller has conscientiously adhered to the owned or rented distinction even if it required a determination that an ATM was a branch under the McFadden Act. For example, in one instance, a national bank proposed to make available to banks in a particular state an ATM "sponsorship" arrangement. Under this arrangement, a sponsoring bank would have been able to station its personnel at the ATM during its first 90 days of operation and have its name listed first in the list of participating banks. A sponsoring bank would have been required to pay the national bank an initial installment charge as well as a monthly rental payment, although the national bank maintained actual ownership. A sponsoring bank also would receive a transaction fee for each transaction originated by customers of other banks on the sponsored ATM.

In response to this proposal, the Comptroller's staff stated that the sponsored ATMs were branches of both the sponsoring bank and the national bank. In explanation the Comptroller's staff states:

> Not only does a sponsoring bank pay a fee that has all the indicia of a rental fee (and one that is so labelled in the contract you submitted), but it also shares in the profits generated by the terminal. Moreover, a sponsoring bank's personnel will be temporarily stationed at the CBCT (ATM). A sponsoring bank will have a stake in the success of the CBCT it sponsors and its name will be prominently associated with the CBCT. Under these circumstances, I believe that a

(Footnote Continued)

In summary, S.206 merely maintains the status quo. It resolves the narrow issue of whether a shared ATM is a branch under the McFadden Act.

The clarification of the definition of a branch is crucial to any legislation addressing this issue because of the explicit intra- and interstate branch limitations in Section 36(c) of the McFadden Act. In addition, the bill delineates the distinctions between "shared" and "established" systems in a sensible manner that is essential to the determination of permissible banking activities.

The bill only preempts such state law as would characterize a shared ATM as a branch of a national or state member bank. /10 It simply does not address

(Footnote Continued)
sponsored CBCT will be a branch of both the (national bank) and the sponsoring bank.

Interpretative Letter from Peter Liebesman, Assistant Director, Legal Advisory Services Division, Office of the Comptroller of the Currency, Fed. Banking L. Rep. (CCH) Paragraph 85,269 at 77,407-408 (1981-82 Transfer Binder) (May 12, 1981).

This ruling not only underscores the rationale for distinguishing between ATMs that are owned or rented and those that are not, it further emphasizes the Comptroller's resolve to ensure that the distinction is enforced. The Comptroller has made a reasoned decision in this area, and his views are entitled to deference.

10/ 12 USC Section 321, as interpreted in Regulation
(Footnote Continued)

broader questions of whether the Comptroller or the state has the authority to regulate the functions performed at an ATM. The complexity and controversy raised by these questions warrants congressional consideration, but it should be in the context of a comprehensive review of the McFadden Act and Douglas Amendment.

Indeed, this need for separate consideration has been recognized. Congressmen John LaFalce, (D.NY) and George Wortley (R.NY) recently introduced H.R. 688, The Banking Convenience Act of 1985. This bill is identical to S.206 and was to be discussed at the Financial Institution Subcommittee mark-up, June 5, 1985. Congressman Tom Ridge, (R.PA) also introduced legislation on the issue. His proposal reverses the Second Circuit case and subjects shared ATMs to state branching laws. So many questions were raised on the differences and effects of the two bills, that Chairman St Germain asked that the bill be withdrawn until hearings could be held.

(Footnote Continued)
H, 12 C.F.R. Section 208.9 requires that branches of member banks must be established on the same terms and conditions as are applicable to branches of national banks under the McFadden Act.

S.1148: The Electronic Banking Competitive Equality Act of 1985

Senator Proxmire, aware of the importance of electronic banking, introduced S.1148. We appreciate the Senator's concern. We cannot support the bill, however, because it substantially changes present law and raises many questions as to its effect on present electronic funds transfer terminal operations. Unlike S.206 which codifies the status quo, Senator Proxmire's bill prohibits interstate deposit acceptance unless a state takes the affirmative step of enacting a law that specifically permits it. The law, thus not only significantly expands state authority over national banks, it also establishes a federal rule that prohibits competitive services from being offered to consumers, until a state legislative body overturns this new federal principle. Currently there is no express authority for states to regulate deposit taking or other functions such as withdrawals or loans at national banks - it is a matter of federal law. In addition, other provisions in S.1148 restrict present shared arrangements and would inhibit their development.

Another concern is that the section does not contain a definition of "deposit" and the broad language could prohibit the following electronic transfers:

o Return at Point of Sale - If a customer returns a purchase made with a debit card at a point of sale terminal, the electronic refund transaction that credited a customers account could be characterized as a deposit to the customer's account.

o Merchant settlement at Point of Sale - The systems often electronically credit the merchant's account for purchases made at point of sale terminals. Again, the settlement transfer could be characterized as a deposit to the merchant's account.

o Transfers between accounts at the same institution - A consumer in Maryland may use a shared ATM in Virginia to transfer money from a savings account into a checking account. This transfer that credits a customers account could be characterized as a deposit.

It is certainly likely that these electronic transmissions could occur interstate. Without a clarifying definition of "deposit" in the bill - they could be prohibited, which would jeopardize the development of POS systems. Furthermore, there are a number of other electronic transmissions that are not presently performed but could be in the future - for example, the transfer by a consumer, of funds to accounts in other institutions - which could be prohibited by this provision.

Section 3(A) of S.1148 defines the word "own" to include "constructive control," but this phrase is not explained. This is a problem because the arrangements of the shared systems vary. Frequently, many institutions are involved in providing services or equipment to the shared system. One company can own the ATM, another may

provide the data links to the ATMs and yet another may provide the switching services. Any of these entities may play the lead role in establishing a shared ATM network or may provide several of the component parts. Any of these constituent contributions could, in various instances, constitute "constructive control." It would therefore be dangerous to include an undefined term such as "control" when there are so many sophisticated arrangements involved, and where the viability of the system depends on confidence in their legality.

The issue of "constructive control" presents problems on two levels. Not only can an arrangement involve different types of entities, (as described in the preceding paragraph) but often, the systems were developed and are owned and operated by a group of financial institutions. Though many more institutions may participate in the network, the originial group operates the system. Conceivably, these arrangements that have efficiently benefited consumers, could violate Section 3(A) of S.1148.

The second problem concerns the difference between proprietary and shared ATMs. Senator Proxmire acknowledges that they are different and should be treated differently in Section 2(i)(1) of S.1148. However, Sections 3(A) and 3(B) which limit the types of

shared arrangements in,effect,could redefine many existing networks as proprietary systems. As a result, the ATMs would be classified as branches of national banks and their current operation would violate the McFadden Act.

At another level, section 3(B) of S.1148 requires a "uniform fee schedule," and Section 3(C) requires "mandatory sharing." Both aspects of ATM systems are now reviewed by the Department of Justice (DOJ) under present antitrust laws.

The Antitrust Division of the DOJ has recently given a good deal of consideration to the antitrust ramifications of joint ventures involving ATM networks. /11 General antitrust analysis provides a useful framework for approaching the question whether a joint venture, such as a shared ATM network, results in an anti-competitive market. The analysis, however, must be sufficiently flexible to accomodate the particular facts of a case. This is especially true in the area of shared ATMs where the consumer be efits are substantial, the

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11/ See remarks of Charles F. Rule on Antitrust Analysis of Joint Ventures in the Banking Industry: Evaluating Shared ATMs, before the Federal Bar Association and the American Bar Association (May 23, 1985).

providers of the service are diverse and the technology is changing so rapidly.

The issues of uniform fees and mandatory sharing are integral aspects of an anti-trust analysis. Their absolute requirement in legislation could seriously undermine the growth and benefits of a shared system. For example, uniform fees may be set at a noncompetitive level, causing a misallocation of resources, which could discourage the efficient placement of ATMs. Conversely, uniform fees could also increase the efficiency of contractual agreements among members of a shared system and increase the overall reliability and value of the system to consumers. The ambiguous results of uniform fees make it impossible to say whether they enhance or harm consumer welfare. A uniform fee structure could have detrimental rather than beneficial results and it should not be federally mandated.

Required uniform fee schedules would also present problems for an increasing number of institutions that have entered into multiple sharing arrangements. Over 25 percent of banks and thrifts that currently share their ATMs are members of two or more shared networks. /12 The

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12/ Steven D. Felgran, "From ATM to POS networks:
(Footnote Continued)

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participation fees vary considerably. They reflect the particular needs and arrangements of each system. A federally mandated fee structure raises many questions as to its scope, would be impossible to administer, and would inhibit the growth of the systems.

There also are a number of disadvantages and advantages associated with mandatory sharing requirements. A particular disadvantage of mandatory sharing is that it may undermine the incentive to innovate , creating a "free rider" problem with respect to initial risk-making. An institution has little or no incentive to invest money in the development of a system if that institution can "wait and see" if the network is successful and then join the network because sharing is mandatory.

Even though approximately one-half of the states require sharing in some form, the arrangements may still be vulnerable to antitrust liability. /13 Furthermore, since cost efficiencies are realized in direct proportion to the volume of transactions, many networks have liberalized their sharing policies. There is no need for

(Footnote Continued)
Branching, Access and Pricing," New England Economic Review May/ June, 1985, p. 49.

13/ Ibid., page 6.

federal regulation where the marketplace is acting responsibly.

The language in Section 4 is too vague and presents problems. What is "publicly accessible electronic banking equipment?" Certain specialized terminal devices could fall under the provision and be characterized as branches. For example, an electronic terminal, which provides information about securities and permits their purchase by instructing the bank to pay for the purchase could be considered a branch, even if the terminal is located in a brokerage facility.

CBA submits that these provisions in S.1148 are unnecessary, and that the bill as a whole, improperly delegates control over national bank activities to the vagaries of state legislation. The DOJ is already monitoring ATM arrangements. The systems offer consumers and institutions substantial benefits and they should be permitted to grow without unnecessary limitations.

In conclusion, CBA supports S.206 <u>without any amendments</u> because it codifies the Circuit Court decision. It acknowledges the rapid growth of electronic technology and reaffirms the authority of the Comptroller to interpret the McFadden Act as it applies to technology which was never contemplated when the Act was passed more

that half a century ago. The bill addresses the narrow question raised by recent litigation and leaves the broader issues of antitrust and appropriate state authority in the dual banking system for a forum that would give these issues the extensive consideration they deserve.

PRODUCTS AND SERVICES

A Note on Risk

One of the more important rationales for federal regulation of financial institutions is to ensure the safety and soundness of the banking system. CBA believes this to be of paramount importance in the current discussion of financial deregulation. We also believe that the risks to safety and soundness have been misconstrued, and that some of the ills of the financial system have been blamed on deregulation which in fact has not yet occurred.

There have been failures and near failures of banks and thrifts in record numbers recently. There is also concern over the future failure rate, especially among agricultural and energy lenders, which are export sensitive. In a period of a strong dollar and cheap imports, these institutions, with assets concentrated in one segment of the economy, are particularly vulnerable.

The other cause of recent failures is criminal misconduct which has gone undetected by our regulatory apparatus. Insider abuses, falsification of records and chain banking abuses have accounted for several celebrated failures.

But neither concentration in energy or agricultural loans, nor criminal misconduct, has any relation to deregulation. Little real deregulation has occurred to date. Few new banking products or services have been authorized. To believe otherwise is a crucial misperception that lacks proper focus.

Healthy deregulation will enhance the safety and soundness of depository institutions. A key component of sound corporate management and stable growth is diversification. While the bank failures of the Depression have been blamed on banks' activities outside of banking, the record shows many failed because of a lack of diversification, because they were concentrating their lending in one industry such as oil or agriculture. The same is true of recently publicized failures.

Diversification of both products and geographic base would provide consumers with a wider choice of financial services. It would also provide institutions with a

wider base of profitability, making them stronger and the system more sound.

And what of the risk in these new diversified services?

While we support a wide range of new powers and open competition, many of the most contentious issues before the Committee involve the least amount of risk. For example, there is no risk to the institutions in selling insurance, other than that no one buys it. The same is true of securities brokerage. The bank takes no position in the securities, and therefore takes no risk.

We believe a number of other expanded powers are proper for banks and thrifts, but we use these two as dramatic examples that deregulation and soundness are compatible. Deregulation and diversification simply are not synonymous with greater risk. The only reason for opposition to these modest expanded powers is the protection of those already offering such products.

A final note on risk: if banks can take the risk of signature loans, of mortgages, of small business loans, of car loans, and of many other lending activities, is there any comparable risk in insurance sales or securities brokerage? The answer is "no." The answer is also

"no" in the matter of many types of insurance underwriting where reinsurance and actuarial tables remove much of the risk. And banks would not place themselves at additional risk if they could engage in other forms of diversification such as underwriting municipal revenue bonds.

Since banks are already risk managers, it is time to give them the diversified tools necessary to perform their assigned roles.

INSURANCE POWERS

The Competitive Environment

The financial services marketplace is characterized by ever-increasing inter-industry competition and by a general trend toward integration between the insurance, banking, securities, real estate, and retailing industries. While other financial services institutions, such as Sears, Merrill Lynch, Prudential-Bache and Shearson--American Express are permitted to enter traditional banking markets, regulatory constraints preclude commercial banks from competing for the consumers' financial business by providing a full line of products and services to satisfy their needs. Furthermore, many of the financial products provided by these competitors are

functionally and practically similar. For example, a whole life insurance policy is similar to a tax-deferred savings account and a variable life policy is a form of tax-deferred money market fund. Both insurers and banks offer IRA/Keogh accounts, savings certificates at money market rates, consumer and commercial loans and a growing variety of other financial products and services.

In addition, bank competitors are packaging diverse forms of financial products and offering them in convenient one-stop shopping centers. This is part of a growing trend to provide banking, credit, insurance, securities and real estate services in retail stores.

For example, J.C. Penney, Montgomery Ward, Kroger and K-Mart, as well as Sears are selling insurance and other financial products in their stores and supermarkets. Unless banks are permitted to offer the same variety of financial services, competition from less restricted firms will attract a growing share of traditional bank customers. We should remember the lessons of Regulation Q constraints on interest rates. When the money market funds offered the public market rates of interest on their savings, billions of dollars in deposits flowed out of bank accounts, and many consumers found that they could obtain bank services from securities firms, insurance companies and other providers.

One of the major areas of the financial services market barred to banks and bank holding companies is the general business of insurance. At the same time, leading insurance companies have for some time been positioning themselves to meet customers' demands for comprehensive financial services. Insurance companies, securities firms, retailers and others are now leveraging existing customer relationships by expanding into related financial services and cross-selling their products and services.

Today, insurance companies offer their customers a growing variety of banking, investment and real estate services. For example, Prudential-Bache cross-sells products using referrals from its insurance agents, to offer home mortgages to policy holders and investors. Table 1 provides further examples of the integration of insurance and banking.

Table 1

Examples of the Expansion of Insurance into the Financial Services Industry

o The Travelers Insurance Corp. owns an FDIC insured commercial bank, the Massachusetts Companies, and Brokers Mortgage Service, Inc., a firm that originates, sells and services home loans.

o Prudential owns Prudential Bank and Trust, a securities firm (Bache) and a real estate company. It has also entered the home mortgage market.

o New England Mutual Life acquired a savings bank.

o Metropolitan Life is selling insurance in branches of Mercantile Bank, St. Louis.

o Equitable Life will sell life, health and annuity insurance in Bank of America branches.

o Aetna Life & Casualty sells insurance in Tennessee bank branches via an independent insurance agency.

o Mutual Benefit Life owns Mutual Benefit Trust, R.I.

o Northwestern Mutual Life is buying a major share of M&I Corp., a $3.4B asset bank holding company in Wisconsin.

o Allstate Insurance is owned by Sears, which also owns two banks and a S&L, a major investment house (Dean Witter), and a real estate company (Coldwell Banker). Sears has over 300 financial centers nationwide offering the products of these subsidiaries to store customers.

o Family Life Insurance is owned by Merrill Lynch, which also owns a bank and a real estate firm.

o Fireman's Fund and IDS insurance companies are owned by American Express, which also owns two banks, a mortgage company, and a securities firm (Shearson).

o J.C. Penney Life and First National Bank of Harrington, Del., are owned by the retailer. The department store chain sells its insurance products in hundreds of stores nationwide.

o Acacia Mutual Life owns a discount brokerage, and operates a mutual fund and Acacia Federal S&L, Va.

o Capital Holding Corp. owns National Liberty Insurance, First Deposit Life Insurance, First Deposit National Bank, N.H., and First Deposit Savings Bank, Ca.

o Hutton Life, Hutton Trust Co., and E.F. Hutton Bank are owned by E.F. Hutton.

o Alexander Hamilton Life is owned by Household International, which also owns Valley National Bank and three savings and loan associations.

o American Centennial Insurance, Central National Life and Beneficial National Bank are owned by the Beneficial Corp.

o Both Cumberland Life and Associates National Bank are owned by Gulf and Western Corp.

o Paul Revere Insurance, six other insurance companies and Anaheim National Bank are owned by AVCO.

o Leucadia National is an insurance holding company that owns Charter National Life and American Investment Bank, Vt.

o American Title Co. is owned by Glendale Federal S&L Association.

o John Alden Life and United Fidelity Life Insurance Companies are owned by Great Western Financial Corp., a S&L holding company.

Despite the rapid expansion by insurance companies into the banking business, most insurers and agents strongly oppose efforts by banks to offer insurance products. One reason given for such opposition is that banking and insurance have traditionally remained separate and should continue to be kept apart. But the realities of the marketplace have blurred outmoded distinctions between providers of financial services.

The integration of insurance and banking cannot be denied or reversed, since it is in response to the demands for a complete line of financial products and services, that can satisfy consumer's individual needs.

Another reason for opposing industry integration is the fear that economic resources will become concentrated. This argument cannot be supported, for several reasons. The banking industry, with some 15,000 competing institutions, shows no signs of concentration. Neither does the insurance industry with 5,000 companies. As noted earlier, the integration of insurance and banking that has already taken place has not resulted in any measurable concentration of resources. Furthermore, the banking and insurance industries are thoroughly regulated, both by government agencies and by the competitive environment that characterizes the two industries. These factors should provide more than adequate assurances for those who fear that bank entry into insurance will adversely affect the public interest.

Unlike those who are trying to prohibit inter-industry competition, we do <u>not</u> favor restrictions on other financial services providers that wish to offer deposit products, loans and other banking services. To the contrary, we welcome competition between insurance companies and banks, so that they may provide the best

financial products and services at the lowest cost. In the interest of fairness, we ask for competitive parity between all segments of the financial services industry. The consumer will be the major beneficiary of open competition.

Consumer Benefits

In the dispute between the insurance and banking industries over the financial services market, consumers' needs and wishes have been virtually ignored. Yet, numerous surveys and actual market experience provide substantial evidence that the public would welcome the opportunity to obtain insurance from their banks.

For example, a recent study sponsored by the Federal Reserve Board and the Comptroller of the Currency showed that 6.5 million households would purchase property and casualty insurance from banks, and that 11 million households are interested in buying life insurance from banks and thrifts. /14

A recent survey of consumers by the life insurance industry found that 59% of respondents believe that banks

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14/ Survey of Consumer Finances, Mathematica Information Services, November, 1984.

would do a good job of providing one-stop financial services (including insurance) compared to only 16% for life insurance companies. Consumers rated banks highest in terms of quality of service, respect for individual privacy, treatment of people as individuals and giving people their money's worth. The survey also found that many respondents would prefer to purchase life insurance from a life insurance department in their banks or a one-stop financial center, rather that from an agent. /15

Another consumer survey sponsored by insurance companies, banks and others found that while 33% of consumers prefer to purchase insurance from insurance companies, most (67%) prefer such alternative sources as banks, brokerage firms and department stores. Among those who prefer other ways to purchase insurance, nearly half said they would like to purchase life insurance and homeowners insurance at a financial services center compared to 45% for auto insurance. /16

While numerous surveys show various levels of interest by consumers in obtaining insurance from banks,

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15/ The 1984 MAP Survey, American Council of Life Insurance, October-November, 1984.

16/ Insurance Distribution Alternatives in the 1980-s, Response Analysis Corporation, December, 1984.

actual experience is often a better guide to future attitudes and behavior. For more that a century, small banks have been involved in selling or underwriting insurance. For example, banks in Minnesota, North and South Dakota, and Colorado have been offering general insurance agency services to consumers for decades. Insurance agency and brokerage activities are currently authorized for state-chartered banks in 16 states. Today, over 1400 state-chartered commercial banks provide general insurance agency services. /17 Consumers have found banks in these states to be a valuable and trusted source of insurance and banking services.

The primary benefits to consumers from bank insurance competition are reduced insurance cost, greater convenience, better information, fairer treatment and more choices. Consumers are increasingly price and value conscious, and are concerned over the rising costs and availability of insurance coverage. A major reason for increases in premiums is the costly, inefficient insurance distribution system, where an average of 25 cents of every dollar in premiums is paid in commissions to agents or brokers and overhead costs. Banks could reduce insurance costs to consumers by at least 10 cents of

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17/ Banks in Insurance: The Real Issue, Transition, May 1984.

every dollar by reducing intermediaries and by using more cost effective methods of distributing insurance.

Convenience is an important factor in the consumer's decision to select a financial institution. Banks can provide consumers with one-stop financial shopping convenience through bank branches and offices in both large and small communities. Here consumers could carry on their normal banking activities, compare insurance products and perform other financial transactions.

Consumers are often confused by the complexity and the terminology of existing insurance contracts and sales practices. If banks are permitted to offer insurance, there will be a competitive incentive by both insurers and banks to provide clear and complete disclosure of prices, coverages and other contract conditions. Such disclosure will enable consumers to shop for the best insurance rates, coverage and services.

Opponents of bank competition argue that banks will explicitly or implicitly require borrowers to obtain insurance as a condition for obtaining credit. Similarly, the insurance industry has been accused of tying practices that condition insurance coverage for one policy on the purchase of another. In fact, since there will be more competition between suppliers, even implicit

coercion will cause consumers to seek alternative sources of credit and insurance.

The more competitors there are, the less chance that any single provider has the power to coerce or compel consumers into purchasing insurance from that source. Therefore, entry into insurance by depository institutions will provide another level of consumer protection against unfair or coercive practices.

The U.S. Justice Department's Antitrust Division reviewed this issue in commenting on an FDIC proposal to expand bank powers into insurance activities. Their comments in November of 1983 read in part:

> "Participation by banking organizations in a broader range of financial activities would be unlikely to result in a significant increase in anticompetitive tying arrangements. The offering of two services or products as a package may represent an economically efficient means of conducting business. Absent market power, a firm cannot restrain competition by such a practice. Given the usual diversity of choices available to the financial services customer, it is generally unlikely that a particular provider of such services possesses the requisite market power to effect an anticompetitive tie. In any event, existing antitrust laws provide adequate protection against anticompetitive ties, whether undertaken by a banking organization, another type of supplier of financial services, or any other type of firm."

Clear and explicit disclosure of alternative sources of insurance and a reasonable period of time (e.g., 30

days) to cancel insurance, protects consumers from coercion by enabling them to shop for the best rates, coverage and service. Finally, consumers are protected against coercion by law. Laws prohibit tying arrangements imposed by state or federally chartered banks, thrifts, bank holding companies and their subsidiaries.

Allowing banks to offer insurance will substantially increase the number of insurance providers and products available to consumers. Banks are well aware that consumers want the best yield on their savings and the most favorable loan rates. Similarly, consumers are demanding more valuable insurance products to meet their changing needs. As competition for the insurance dollar increases, both banks and insurers will develop new insurance products to meet these demands.

In sum, the result of allowing banks to become insurance providers would be a better informed consumer, supplied with a wider choice of products at lower cost.

State vs. Federal Regulation

Under the McCarran-Ferguson Act of 1945, Congress granted the states authority over the permissible insurance activities of state-chartered institutions. In

addition, the dual banking system authorizes the states to regulate state-chartered banks. A number of states have authorized state-chartered banks to offer insurance to the public. Table II (page 60) lists 16 states that permit agency or brokerage powers, (including 4 states that also permit underwriting) and 6 states that are silent on bank insurance powers. In addition, other states are considering legislation to permit banks to offer insurance.

The insurance industry is strongly opposed to federal regulation of insurance, yet it continues to urge Congress to preempt state authority over insurance activities of state-chartered banks. Consequently, legislation has been introduced in both the Senate and House that would restrict the insurance activities of bank holding company subsidiaries and affiliates beyond those already proscribed under Title VI of the Garn-St Germain Act, and would limit the activities of state-chartered banks outside the home state to those authorized for national banks under Section 4(c)(8) of the Bank Holding Company Act. The Garn-St Germain Act did not preempt the right of individual states to

Table II
Authorized Insurance Activities of State Chartered Banks

State	Underwriting	Agency or Brokerage	Silent
Alabama	X	X	
Alaska			X
Arizona			X
Delaware	X*	X	
Indiana		X	
Iowa		X	
Maryland		X	
Minnesota		X	
Mississippi		X	
Missouri		X	
Montana		X	
Nebraska		X	
No. Carolina	X	X	
No. Dakota			X
Oklahoma			X
Oregon		X	
Rhode Island		X	
So. Carolina			X
So. Dakota	X		
West Virginia			X
Wisconsin		X	
Wyoming		X	

* Only for 3 grandfathered institutions.

regulate insurance. It did, however, provide a number of exceptions to the prohibitions on insurance activities of bank holding company subsidiaries.

These exceptions include the ability of banks to engage in insurance agency activities in locations with populations not exceeding 5,000 inhabitants and additionally, to engage in such activities in any location having inadequate insurance facilities. The exceptions in Title VI further support the view that Congress did not intend to prohibit all affiliations between banks and insurance companies or to establish a policy against all such affiliations, because Title VI permits the continuation of all insurance activities previously approved under subsection 4(c)(8) prior to May 1, 1982, and also permits all bank holding companies with assets of $50 million or less to engage de novo in insurance agency activities. Title VI does not eliminate or restrict existing affiliations between banks and insurance companies.

The insurance industry would prefer to see all these exceptions eliminated to prevent competition from banks and to impede marketplace responses to consumer demands. It would go further and preempt state authority to regulate the insurance activities of state-chartered banks, while upholding state regulation of insurance.

We believe Congress should not cripple the ability of the states to regulate the insurance activities of state-chartered financial institutions. Restrictive federal legislation would place banks at a further competitive disadvantage vis-a-vis insurance companies, retailers, and other non-bank financial institutions.

Furthermore, such legislation is not in the best interest of consumers, since it denies them the opportunity to obtain insurance at a lower cost, and more conveniently.

Existing state regulatory authorities can adequately protect the public interest and ensure the safety and soundness of financial institutions. Regulation of insurance practices of banks and bank holding company subsidiaries can be handled by each state's insurance department and banking activities of insurance companies can be regulated by the appropriate banking regulator. Regulators already have the means to deal with bank/insurer affiliations, and have the necessary licensing and examination powers to handle actual or potential problems.

Most states have adopted the National Association of Insurance Commissioners' Model Unfair Trade Practices Act which prohibits unfair methods of competition, and unfair

or deceptive acts or trade practices. Banking institutions engaged in insurance would be subject to this law just as insurers are today.

Thus, the expertise of the regulators will continue to be utilized and the safeguards developed over the years will remain in place. The public will remain protected against unconscionable practices and the safety and soundness of all financial institutions will be maintained.

Conclusion

The rationale for broader insurance powers for banks and bank holding companies is overwhelming. The marketplace continues to shape and direct the financial services industry. Changing consumer demands and lifestyles, increased competition for consumers' funds, and the economics and technology of distribution systems reflect some of the driving forces of the market. Attempts by protectionists to hold these forces in check will ultimately fail.

Open competition in the insurance and banking industries will primarily benefit consumers, who will be able to reduce their premium costs, increase convenience, obtain better information and fairer treatment, and have

access to a wider range of choices among insurance products and providers. There will also be significant benefits to insurance companies and agents, who can reduce their distribution costs, access a broader customer base and increase marketing productivity.

It is time for the insurance and banking industries to take a broader view of the emerging financial services industry. Rather than resisting change and competition, we should be planning and developing the best products and services to meet the demands of the marketplace.

SECURITIES ACTIVITIES

CBA strongly supports the expansion of permitted securities activities for depository institutions. In this context we would like to outline briefly, as a predicate, the history and basis of the Glass-Steagall restrictions on bank involvement in securities activities, then discuss more fully the specific types of securities activities in which depository institutions should be permitted to engage.

The Glass-Steagall Act was enacted in 1933 in response to very specific circumstances. At that time, in the depths of the Great Depression, it was generally believed that among the causes of the many bank failures

was the significant involvement of commercial banks in investment banking through securities affiliates.

The purpose of the Glass-Steagall Act was to protect against the hazards that were attributed to the then largely "unregulated" combination of commercial and investment banking. The Glass-Steagall Act, however, never established an absolute wall between securities and banking activities, for it did permit banks to engage in various securities activities, such as underwriting general obligation bonds and purchasing and selling securities for the account of bank customers.

Conditions have changed dramatically during the fifty years since Glass-Steagall was enacted. Technological, economic, and market changes have, in effect, turned the Act into an anachronism and a barrier to economic growth. The growing involvement by securities firms in what traditionally have been perceived as banking activities demonstrates the natural affinity of these activities. But the complementary natural growth of depository institutions is thwarted by this outmoded statute. A statutorily imposed artificial wall between securities and banking activities is no longer tenable or desirable in today's business environment.

Municipal Revenue Bonds

CBA believes that the easiest task before this Committee and the Congress is to allow depository institutions to engage in the underwriting of municipal revenue bonds, including industrial development bonds. This proposal has been before Congress many times and has, in fact, been passed by the Senate as recently as last fall.

Since 1933, banks have been permitted to engage in the underwriting of general obligation bonds. Municipal revenue bonds were an insignificant part of the municipal bond market in 1933, but they have grown to be the largest single segment of that market.

It makes little sense today to prohibit depository institutions from underwriting revenue bonds. This logical extension of bank authority is strongly supported by depository institutions and state and local governments. We support initiatives such as those debated last year by this Committee that would eliminate this historical impediment that prevents depository institutions from offering this service to local governments and the investing public.

There is very little difference between industrial development bonds and municipal revenue bonds, and little

increase in risk to the depository institution between underwriting industrial development bonds that are truly for a "public purpose" and underwriting traditional municipal revenue bonds. Therefore, depository institutions should be permitted to underwrite both types of obligations.

Investment Companies

CBA supports legislation that would allow depository institutions to sponsor, operate, underwrite, and distribute the shares of all types of investment companies. A proposal of this sort was deleted from S.2851 during the deliberations of this Committee. This issue has been fully aired before this Committee on numerous other occasions, as well , and enactment of such authority is long overdue.

The pressure on banks to offer services competitive with mutual funds have lessened somewhat since the Garn-St Germain Act authorized the money market deposit account. Banks, however, are still eager to offer the full panoply of mutual fund services, such as tax-exempt and corporate bond funds, that other financial service providers can offer to their customers. The ability to offer such funds is a natural complement to the provisions of retail deposit and banking services.

Since investment companies are separate legal entities, regulated by the Securities and Exchange Commission and registered under the Securities Act of 1933, permitting depository institutions to organize and manage these funds poses little additional risk to the institution or the public. Various existing securities law provisions, especially those in the Investment Company Act restricting affiliate transactions, as well as relevant banking law regulations, would be effective in preventing the types of subtle hazards contemplated by Glass-Steagall.

Allowing depository institutions to sponsor investment companies can only result in public benefit by increasing the number and nature of such funds available to the investing public and by placing depository institutions on a more equal footing with other financial service providers.

OTHER RETAIL PRODUCTS

This Committee considered legislation last year that would have authorized bank holding companies to engage in "activities of a financial nature."

CBA strongly believes that the authorization of the broadest possible range of activities would provide the

public with the benefit of increased competition between bank holding companies and other firms engaged in activities of a financial nature. We therefore recommend the inclusion of such an initiative in this years Committee deliberations.

CONSUMER LEASING

NATIONAL BANK ACT LEASING AMENDMENT

We would ask that the Committee reconsider passage of legislation such as Section 111 of S. 2851, a provision that would have amended Section 5136 of the Revised Statutes, clarifying the authority of national banks to engage in leasing. Currently, the leasing authority of national banks is a matter of interpretation and court decisions defining national banks' lending powers. Because of this patchwork approach to leasing authority, national banks are subject to certain limitations in their leasing activities that are designed to make leases the functional equivalent of loans. These limitations are unnecessary and burdensome, and should be relieved by making explicit the authority of national banks to engage in leasing activities. In addition, and in keeping with our principle of parity, Section 330 of the Garn-St Germain Depository Institutions Act of 1982 gave to the thrifts the power later contained in Title 1, Section 111, of S.2851.

Comptroller of the Currency, T.C. Conover, in a letter to Senator Paula Hawkins dated November 1, 1983, endorsed the proposal. Mr. Conover wrote that "such additional authority is necessary at this point to bring about competitive parity between national banks and thrift institutions."

CONSUMER LEASING DISCLOSURES

In a related matter, we also ask that you reconsider revisions to the Consumer Leasing Act this session. The Consumer Leasing Act was adopted in 1976 and implemented in March of 1977 to provide disclosures for consumer lease transactions recognized by Congress as an increasingly popular alternative to instalment credit transactions. Initially, lease provisions were incorporated into the Truth in Lending Act and Regulation Z, the regulation that implements that Act.

When the Truth in Lending Act underwent extensive revision in 1980, however, Congress decided to postpone suggested revisions to the leasing provisions. As a result, the numerous determinations made by Congress as they related to credit transactions have not yet been reflected in the Consumer Leasing Act. In a non-substantive first step in this process, the Federal Reserve Board reorganized its regulation and placed the

leasing provisions in an independent regulation, Regulation M.

Last session, this Committee considered applying these same simplification and reform policies to consumer leasing. While the current rules have in large part performed their intended role, a number of areas remain in need of attention and revision. Many of these issues would be resolved by legislation similar to that drafted by the Federal Reserve Board and contained in Title V - Consumer Leases and Rental-Purchase Agreements Act of S.2851. Regretfully, the Board's proposal falls short of reforming the Consumer Leasing Act in a comprehensive way and of extending to leases the determinations reached by Congress during the simplification of the Truth in Lending Act. The Board itself recognized the likely need for further amendments to its proposal in its transmittal letter to Senator Garn.

Background

Consumer leasing provided by financial institutions tends to be regional in nature, concentrated in large part in the western states and particularly in the state of California. These financial institutions engage almost exclusively in long-term automobile leasing, by either directly leasing cars to consumers and businesses,

leasing through holding company affiliates or subsidiaries, or indirectly by buying lease contracts from automobile dealers or independent leasing companies.

There are two types of long-term automobile leases, distinguished by the consumer's liability at the end of the lease. In an open-end lease, the lessee bears the risk of any depreciation that occurs during the term of the lease, though current law generally limits this risk to the total of three monthly payments. In closed-end leases, the consumer is not liable at the end of the lease for market depreciation that has occurred during the lease term. Though financial institutions have traditionally offered open-end leasing, more and more financial institutions are engaging in closed-end leasing, and we expect that this trend will continue over the next decade.

A consumer who leases a car is, in an important way, obtaining a different product than a car purchaser. The lease normally requires little or no downpayment, freeing capital the consumer would otherwise tie up in a car purchase. A person leasing directly from a bank or from a leasing company subsidiary of a bank holding company merely informs the lessor of the vehicle desired, and the lessor takes care of ordering and obtaining the car. At

the end of the lease, the consumer simply returns it to the lessor.

Proposed Changes

We will comment in terms of the provisions in Title V of S.2851 since they will probably form the basis for any new bill. Title V also included short term leases called, "lease purchase agreements," that primarily covered rentals of televisions and appliances. CBA will comment only on those proposals applicable to long term leases as our members experience is exclusively in this area.

Disclosures for Long-Term Leases

In general, CBA supports provisions comparable to last year's Title V. It moved a long way toward the goal of reducing both the number and complexity of disclosures required by the Consumer Leasing Act. But it contained disclosures for long-term leases that we believe are contrary to both the principles adopted by Congress in the Truth in Lending reform effort and the objective of providing consumers with meaningful and usable disclosures.

The most difficult problem is presented by the proposed requirement of a "total lease cost" disclosure

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for long term leases. The total lease cost would be the undiscounted sum of all payments, calculated by adding all initial payments, all periodic payments, and all payments due at the end of the lease term.

The Division of Research and Statistics at the Federal Reserve Board strongly argued that the disclosure be deleted. That division recognized the difficulty and potential for misleading consumers that would stem from the fact that the total cost, calculated in this manner, does not reflect the differences in the amount and timing of payments and, therefore, inaccurately represents the consumer's opportunity cost of funds. This disclosure also ignores the role of security deposits, and the available options of including insurance premiums, taxes, or other official fees, in quantifying the true cost of the lease to the consumer.

In other words, a lease with a large initial payment, smaller monthly payments, and a large security deposit can result in the same "total lease cost" disclosure as one with small initial payments, larger monthly payments, and a small security deposit. But the second lease may be substantially less expensive than the first, since it encumbers less of the consumer's money over the term of the lease. The total cost disclosure may or may not reflect the cost of insurance and official fees and

taxes. As a result, this disclosure can be a misleading approximation of the true cost and will not be particularly useful to the consumer.

The section-by-section analysis accompanying the Board's proposal recognized this imperfection, but justified the disclosure on the basis that the other information necessary for the consumer to determine which lease is actually less expensive is given by the other disclosures. We do not believe that a consumer who sees one lease disclosure that says "total lease cost: $4956.85" and another that says "total lease cost: $4841.92" is going to stop to calculate his or her opportunity cost of funds. The fact that the number is a federally-required disclosure will only add to the consumer's assumption that the second lease is less expensive.

At the same time, there is no practical way to provide the consumer with an accurate disclosure reflecting the cost of the lease. This was recognized explicitly by the Board's Division of Research and Statistics, which pointed out that in order to assure truly comparable disclosures a standardized lease structure would have to be imposed on the industry. It was implicitly recognized by the Board itself, which despite the internal criticism of the total lease cost disclosure, did not

attempt to devise an alternative method of comparing cost.

We believe consumers are given sufficient information to reach their own conclusions about which lease is best for them. It is a simple task for them to add up the components of the total lease cost if they want an aggregate dollar figure. To make it a required disclosure carries with it an implicit statement that the figure represents the true cost of the lease that can be compared with other leases to determine which is the least expensive. As demonstrated by the Board's economists, it does not do so.

The second disclosure problem relates to the required initial disclosure of official fees and taxes payable over the term of the lease where these fees are paid to the lessor. It is difficult to estimate them accurately and the consumer would be better served by a disclosure that stated the current costs with a note that they will be a component of future charges but that the amount may change.

Civil Liability

Under the Consumer Leasing Act, as under the Truth in Lending Act, statutory damages of $100 to $1,000 may be awarded for violations of disclosure and other provi sions. Although some form of statutory damages seems firmly entrenched in the consumer credit area, these damage awards in fact involve a radical departure from the normal rule in civil litigation, since they may be awarded without any showing of actual injury or loss to the consumer.

The statutory damage provision resulted in a massive number of lawsuits under the original Truth in Lending Act, and when that law was revised in 1980, it was determined that statutory damages should be awarded only for violations of truly important disclosure or other requirements. Section 130 of the Truth in Lending Act was amended to specify those disclosure terms that are so important for credit shopping, or that play such a key "alert" function, that their misdisclosure should give rise to statutory damage liability.

This distinction should be made in the Consumer Leasing Act as well. The Board, which historically has held the view that its involvement with civil liability questions would be inappropriate, would continue the

current law under the Consumer Leasing Act and permit statutory damages to be awarded for any violation of the Act (excluding only the advertising requirements).

CBA has attempted to delineate those disclosure and other requirements that are of such key importance to consumers that statutory damages may be justified. In doing so, we believe that we have faithfully followed the determinations reached by Congress when it reformed the comparable provisions apply under Truth in Lending. Under both versions, actual damages, costs, and attorneys' fees would continue to be available to all successful consumers for any violation of the law.

We propose that statutory damages be available only for the following violations:

- Failure to make disclosures to a primary obligor at or before consummation
- In long term leases, failure properly to disclose
  - initial payments
  - payment schedule
  - liability upon scheduled expiration
  - the special open-end lease disclosures
- Failure to comply with the substantive protections relating to the three-payment rule and the consumer's appraisal rights

These provisions are the most important ones to consumers, and statutory damages, if justified at all, are most justified in connection with them. Once again,

this suggested resolution merely incorporates the congressional decisions made in the Truth in Lending Simplification and Reform Act.

Although lessors have not experienced the flood of litigation associated with the Truth in Lending Act statutory damage provisions, the Consumer Leasing Act provides the same opportunity for abusive and nuisance litigation. Further, as leasing becomes more popular, the lure of statutory damages for minor, technical violations will bring a correspondingly larger number of nuisance suits before the courts. We believe that the limitation on the availability of statutory damages should be an important element of any revision of the Consumer Leasing Act.

Title V of S.2851 departed from the Truth in Lending Act by imposing civil liability for violations of the advertising requirements of the Consumer Leasing Act. To us, it is inappropriate for lessors to be liable for advertising violations when lenders and credit sellers are exempt from the same liability. The advertising provisions are typically enforced under the Truth in Lending Act, at least with respect to financial institutions, in the course of normal examination by state and federal financial institution regulators. The Federal Trade Commission has authority to enforce the advertising

requirements against other creditors and lessors. These mechanisms operate no differently in the leasing area, where the same agencies have the same enforcement authority. There appears to be no reason to invite civil litigation by consumers as well.

Relation to State Laws

A troublesome issue with any federal disclosure statute is the relation between the federal law and any state laws that require disclosures in connection with the same transactions. The current Consumer Leasing Act provisions regarding state laws provide for preemption of "inconsistent" state laws, except where the state law provides greater protection or benefit to consumers.

The Board has interpreted this current preemption standard to mean that if a lessor can comply with state law without violating federal law, the state law provision is not preempted.

The result is that lessors in states with lease disclosure laws are generally required to make both the state and the federal disclosures, and disclosure statements are lengthy, complex and redundant.

Title V of S.2851 made a relatively minor change in the standard by which state laws are determined to be inapplicable. It would have eliminated the current law's "greater protection or benefit" standard, but would continue to exempt lessors from state requirements only to the extent that those requirements are "inconsistent" with federally mandated disclosures. If that standard is interpreted by the Board in the way the identical standard is interpreted under the Truth in Lending Act, the Board would preempt only those state laws that directly contradict federal disclosure provisions. Thus, lessors would still have to comply with federal disclosures and whatever additional disclosures are imposed by state law.

While most states do not have leasing disclosure laws, those that do frequently require many of the same disclosures that are mandated by the present Consumer Leasing Act. Passage of a bill similar to Title V would eliminate a number of the current federal disclosure items, due to a congressional determination that the marginal information they provide is not offset by the confusion and "information overload" they create. The present and proposed "inconsistency" standard, however, could permit states to retain most of their disclosure rules, thus rendering the congressional determination meaningless. In those states that require additional disclosures, the methods of disclosure may differ, and

consumers in those states will continue to receive disclosures that are confusing and redundant.

In fact, the problem may even be exacerbated because Title V would have segregated the federally mandated disclosures into a "federal box" similar to that required under Truth in Lending. When additional terms are required by state law, these would have to be disclosed outside the federal box, thus adding to the length and confusion of the lease documents.

CBA would like to propose a new standard for determining exemption from state law disclosure requirements. Under CBA's proposal, lessors would be exempted from compliance with state disclosure laws that are "comparable" to the specific terms and conditions of consumer leases disclosed under federal law. Under this standard, state laws requiring more disclosures, different disclosures, or more detailed disclosures concerning consumer leases would be preempted.

An exception would be made for those state-required disclosures that relate to specific contractual terms and conditions imposed by state law. For example, a state disclosure provision that requires disclosure of the lessor's warranties would be preempted because it relates to the terms and conditions of a consumer lease that is

subject to disclosure under federal law. But if the state requires that a particular warranty be given, and also requires a disclosure relating to that state-imposed warranty, the state law would not be preempted.

Adoption of this standard would not result in the wholesale preemption of major state disclosures for leases. A number of those states that do require disclosure, moreover, adopted their disclosure laws before the enactment of the Consumer Leasing Act. Both the 1969 and the 1974 versions of the Uniform Consumer Credit Code (UCCC) include leasing disclosures, and while they do not explicitly defer to federal law as they do with respect to credit cost disclosures, that should not be read as a state determination in favor of duplicative disclosures. Rather, the UCCC's lack of a deference on leasing disclosures is undoubtedly due to the fact that at the time these uniform laws were drafted, there was no federal legislation in the area to which to defer.

Adoption of a broad preemption standard would be beneficial to both consumers and lessors. Consumers would be spared the complex and lengthy disclosures imposed by state law and would have their attention properly focused on the key disclosures required by federal law. Lessors would be spared both the expense and administrative burden associated with compliance with

both state and federal law, and those operating in more that one state would be able to use one set of forms rather than having to produce separate forms for each state. At the same time, lessors would be free to incorporate any items they wished to include as matters of contract, but without the threat of state disclosure sanctions.

The Consumer Leasing Act is an appropriate context in which to experiment with this new preemption standard. The standard would displace the laws of relatively few states. At the same time, it would give Congress an opportunity to examine a different type of preemption provision. Annual reports from the Federal Reserve would keep Congress informed of developments in that area, permitting a reassessment of the broader preemption standard if that appears warranted in the future.

CBA would also ask the Committee to consider an amendment that would affect a small number of state laws and court decisions that attempt to regulate consumer leases by recharacterizing them as credit sales, loans, or secured transactions. In effect, these state laws subject consumer leases to substantive regulation "through the back door." The difficulty presented by these laws and decisions is that the provisions were

designed for very different transactions and make no sense in the context of leasing.

For example, the Pennsylvania and North Carolina legislatures have amended their laws so that certain renewable leases have been recharacterized as retail instalment contracts or credit sales for disclosure and certain other state law requirements. If a bill similar to Title V is enacted, lessors in these two states will have to comply with state laws that require disclosures relating to credit transactions, and also with federal law that requires lease disclosures because the transactions would be covered by the definition of a lease under the proposed amendments to the Consumer Leasing Act.

Our proposal would prevent this anomaly and the resulting consumer confusion. We believe that leasing should be regulated. But we submit that leases differ from credit transactions and should be regulated differently. Congress recognized the difference, by treating them under the Consumer Leasing Act rather than the Truth in Lending Act. This amendment would ensure that Congress' determination be recognized by the states.

Under our proposal, a state could still decide that consumer leases should be subject to substantive limitations or regulations applicable specifically to them.

Our proposal would only affect state laws to the extent that they recharacterize consumer leases, as defined by the Act, as some other type of transaction. It is in that sense similar to, but less invasive than, the provision of the the Cash Discount Act that prohibits states from characterizing a cash discount as a finance charge for purposes of the state's usury or other laws.

We believe that in those areas of law where the federal government has considered, analyzed, and made clear judgments and decisions, its determinations should be uniformly applied without regard to state law. This statement reflects nothing more than the general rule that applies in all cases in which federal and state laws overlap.

This principle is as valid in the area of substantive rights and obligations as it is in the area of disclosure responsibilities. We therefore urge this Committee to consider adopting, at least on an experimental basis, a federal preemption standard that would override substantive state laws that characterize differently transactions that Congress classifies as leases in this legislation. In this as in all other areas where Congress has legislated, its decisions should be the controlling word on the issue addressed.

OTHER UNRESOLVED BANKING ISSUES

Before concluding our testimony today, we wish to reiterate our support or concerns with respect to some important but largely unrelated issues that were addressed by this Committee in last year's legislation. These issues include deposit availability, manufactured housing sales finance disclosure, adjustable rate mortgage limitations, and credit deregulation.

DEPOSIT AVAILABILITY

Customers of depository institutions are entitled to have the use of deposited funds as rapidly as possible, consistent with principles of efficiency and with the safety and soundness of the payment system. However, the imposition of delayed funds availability is the result of a fundamental flaw in the check collection system that adversely affects both banks and their customers. This flaw stems from the manual system of processing returned checks and is not easily remedied. Since delayed funds availability is an interstate problem, it calls for a federal solution. For that reason, CBA continues to support the general approach taken by this Committee last year in dealing with this problem.

In particular, CBA supports legislation that would require depository institutions to provide initial

written disclosures to their customers of the institution's general policy regarding funds availability. We also support the notion that funds deposited in interest-bearing accounts should begin to accrue interest as soon as the bank receives provisional credit. We are quite concerned, however, with proposals mandating rigid check processing time frames or specific disclosure or notification requirements. We believe that such rules would be very costly to banks and to their customers, and could significantly disrupt the efficient operation of the nation's check collection system.

In order to address these concerns in greater detail, we would first like to provide some background on the present check collection system and its impact on the availability of deposited funds.

National Check Collection System

The question of deposit availability must be considered in light of the provisions of the Uniform Commercial Code, adopted by all states, and of the national check clearing system. When one bank takes for deposit a check drawn on another, it must send the check through the national check collection system to obtain the funds the check represents. Checks may be collected through a correspondent bank, the Federal Reserve System, a local

check clearinghouse, or by sending the item directly to the payor bank on which it is drawn. In most cases, some combination of these methods is used.

The forward process of sending a check to the payor bank generally takes one or two business days from the date the check is first deposited. The actual time required will depend on a variety of circumstances, such as the number of intermediary institutions involved, holidays, weekends, weather, and mechanical breakdowns.

After receiving the check, the Uniform Commercial Code requires the payor bank either to pay it or to return it unpaid by midnight of the day following the day it receives the check. The depositary bank receives "provisional credit" for the check from the institution to which it delivers the check according to an availability schedule that reflects normal processing and transportation time for the forward process only, usually one or two business days. Since it is unknown whether the specific check will in fact be paid, any such grant of credit must be provisional and may be revoked if the item is returned unpaid.

Due to the uncertainty of whether it will receive final credit, the depositary bank will be making a loan to its customer if it allows the depositor to withdraw

funds at the same time that the bank receives provisional credit. In this situation, the bank is at risk that the item will be returned unpaid and that the provisional credit will be revoked. If this occurs, the bank may be unable to recover from its customer the funds withdrawn.

The forward check collection process is relatively fast, particularly since Magnetic Ink Character Recognition (MICR) encoding allows the use of high speed processing equipment. The return process is manual, however, and therefore considerably slower.

A returned check must be processed manually because each endorsement stamp on the back of the check must be read to determine to which bank or institution the check must next be returned. Each bank in the return process is required to dispatch a returned check to the next succeeding bank by midnight of the next business day following the day of receipt. Often the institution merely places the check in the mail by the midnight deadline. Accordingly, the return process normally takes at least twice as long as the forward process. There is no incentive for the payor bank to inform the bank of first deposit more promptly that a check has been dishonored.

As a way of eliminating the uncertainty inherent in the return process, some have suggested that the payor bank telephone the depositary bank directly to advise when any item has not been paid. In light of the approximately 125 million checks that flow back and forth across the country every day, this procedure would simply be unfeasible.

Rationale For Delayed Funds Availability

More than ninety-nine percent of all checks are paid upon presentation. It is the fewer than one percent that are not paid that require banks to place holds on the proceeds of some items in order to protect the safety and soundness of the banking system. If banks were not permitted to place holds, they would be open to substantial losses from fraud and ordinary credit risk from funds advanced on items subsequently returned. Millions of dollars are lost in "check kiting schemes" each year. The only way a depositary institution can protect itself fully against fraud and credit losses is to allow depositors to withdraw only against collected funds. Due to the delay involved in notification of return, hold times to protect the bank and its customers may be lengthy.

Another important factor causing banks to place holds is that state and federal regulatory agencies

supervising depository institutions have taken the position that allowing depositors to withdraw against uncollected funds is tantamount to extending credit to the depositor. Such credit extensions must be included in determining whether a financial institution is adhering to applicable legal lending limits and in analyzing whether the institution is acting safely and soundly as required by banking laws.

Need For Federal Legislation

Customer dissatisfaction with the funds availability policies of depository institutions is finding expression in the state legislatures. Some states have already enacted laws to address the problem, and bills are pending in others. CBA recognizes the need to address the problem caused by the structural flaw in the manual handling of return items. No cost-effective solution has yet been found, however, despite considerable study by the industry and the Federal Reserve.

Moreover, we believe that state action in this area can only result in a patchwork of inconsistent requirements that will ultimately degrade the national payment mechanism and may even affect the safety and soundness of the banking system. The check collection system is a national system that should be governed by national

standards. Therefore, we encourage your Committee's efforts to find an equitable and uniform approach and to apply that approach nationwide, pre-empting the conflicting laws of any state.

CBA Recommendations

As previously mentioned, the CBA generally supports several of this Committee's previous initiatives to address the consequences of the structural flaw in the check collection system.

First, we endorse the concept that financial institutions should provide initial disclosures to their customers of their policies regarding funds availability. We have already urged our members on several occasions to make this type of information available to customers in writing or by branch notices. In order to avoid many of the problems depository institutions experienced with the design of the Truth-In-Lending disclosures, we would be happy to provide suggestions to the Committee on this particular section of the legislation.

We also support the concept of crediting interest to an interest-bearing deposit account no later than the date on which the depository institution receives provisional credit for the deposit. Most CBA member

institutions have already begun computing interest either on the date of deposit or when provisional credit has been received.

We are, however, strongly opposed to some of the rigid check processing, endorsement, notification, and liability requirements that have been proposed in the past. Strict return item and civil liability standards do little to address the basic flaws in the check collection system. In fact, such requirements would tend to require an even more labor-intensive and costly effort than the present system, in direct conflict with the concept of devising a more efficient system based on present and future electronic technology.

We believe that there are several avenues that the Committee might fruitfully explore in order to address the basic flaws in the check collection system that we described earlier in this testimony.

First, the Committee might encourage the Federal Reserve System to continue to cooperate with the industry to minimize the effect of the inherent flaw in the check collection system. For example, the banking industry should make a serious effort to acquaint customers with the other services it offers that can provide collected funds far more rapidly. If customers knew that

inexpensive, rapid, and final funds availability could be obtained by using fund transfer mechanisms other than checks, they would specify them when engaging in transactions for which speed and finality are important.

Second, the industry and the Federal Reserve should explore further the possibility of automating the flow of return items, just as the forward check collection process is now automated, so that the depositor and the depository bank will know as quickly as possible if a check is not paid. Automated return item processing would remove much of the uncertainty from the system and reduce the need to delay availability on deposits.

Third, depository institutions should explore revisions to the Uniform Commercial Code in order to establish an incentive for the payor institution to provide rapid notice of dishonor.

CBA would be glad to work with the Committee to develop ways to deal cost-effectively with return item handling in the present check collection system. We all agree that the system requires creative innovations to continue to serve depository institutions and their customers well in the future.

MANUFACTURED HOUSING SALES FINANCE DISCLOSURES

One of the provisions of the Depository Institutions Deregulation and Monetary Control Act of 1980, specifically Section 501, preempts state interest limitations for residential mortgage transactions. The preemption applicable to first liens on mobile homes, however, is conditioned upon the creditor's compliance with consumer protection regulations of the Federal Home Loan Bank Board (12 C.F.R. section 501 (c)-(e)).

The regulations limit prepayment penalties, balloon payments, late charges, and deferral fees, and require an actuarial refund of precomputed finance charges upon prepayment. The creditor is also required to provide the debtor with a thirty-day notice of default and right to cure before accelerating the indebtedness or repossessing or selling the mobile home.

Prior to the enactment of Section 501, restrictive state usury laws inhibited the availability of residential first mortgage loans and mobile home loans. In many states, the usury laws applicable to these types of loans were below the lenders' cost of money. As a result of the Section 501 deregulation of usury ceilings, lenders became very willing to make residential mortgage loans,

including mobile home loans, because they were now able to charge a market rate of interest.

February 1985 estimates indicate that liens on manufactured housing represent approximately $25 billion dollars of outstanding consumer credit. /18 Significantly, the U.S. Department of Commerce's 1981 Annual Housing Survey notes that while mobile homes accounted for only 4.7% of the total number of homes in the United States, they accounted for 10.3% of all owner-occupied homes where the annual household income was less than $12,500. Clearly, mobile home financing represents a major segment of the home finance industry and one which is addressing the needs of low to moderate income persons in particular.

Two recent decisions of the U.S. Eleventh Circuit Court of Appeals, however, could prompt lenders to withdraw from the mobile home lending business and thereby jeopardize access to affordable housing for low income families. /19

18/ 71 Federal Reserve Bulletin A41 (June, 1985). (Actual figures are $24,393,000,000).

19/ Quiller v BarclaysAmerican/Credit, Inc., 727 F. 2d 1073 (11th Cir. 1984); Grant v General Electric Credit Corporation 727 F. 2d 1073 (11th Cir. 1984)

Until these decisions were rendered, the applicable Bank Board regulation was understood by the mobile home lending industry to entail a few straightforward contractual limitations and disclosure requirements. However, as Table 3 indicates, the plaintiffs have, with tentative success, pursued hypertechnical arguments reminiscent of the early Truth in Lending litigation, so as to render the challenged contracts ineligible for their federal usury preemption. The catastrophic result for creditors is that they are faced with state usury sanctions which are far more severe than Truth-In-Lending penalties. State usury laws would void the contracts and award penalties equal to twice the finance charge assessed on each contract. This penalty would average between $20,000 and $40,000 per contract in the cited lawsuits! Moreover, thousands of mobile home contracts could be held in violation of the law based on these decisions.

Last year, the CBA supported a provision in S. 2851 that would have required the Federal Home Loan Bank Board to devise model disclosure forms for mobile home mortgage lending. This would at best be a partial solution to the problems raised by this litigation, however. Left unanswered are questions concerning the risk to existing contracts, the egregious usury sanctions for non-compliance, the Bank Board's general inexperience in consumer credit regulations and its particular failure to

TABLE 3

QUILLER/GRANT CASES

Preemption Act Section 501 (c)(2) Requires:	Grant Contract States:	Court Rules:
"...a 30-day notice prior to instituting any action leading to repossession or foreclosure..."	" In the event of Buyer's default in payment when due, Seller may declare immediately due and payable any and all installments due or to become due hereunder...provided that Buyer shall be given notice of right to cure default before Seller is permitted to exercise that right." (emphasis added)	"...This passage is directly contrary to the statute... because it grants the creditor the right, upon default, to immediately accelerate payment of any and all installments... the qualifying clause (preceding emphasized language) does not remedy the inaccurate statement of the creditor's power...(it) transmits two conflicting messages..."

take any regulatory action to clarify requirements for mobile home financing since these issues emerged more than three years ago.

In addition to the model disclosure language of last year, the CBA strongly recommends legislation which would include cure provisions, moderate Truth-in-Lending type penalties, and a transfer of rule-writing authority to the Federal Reserve Board in recognition of its broader consumer protection experience.

The CBA will be pleased to work with the Committee's staff to craft a legislative response that will once and for all end the market uncertainty that has severely hampered prospective mobile home lending.

ADJUSTABLE RATE MORTGAGES

Last year, a floor amendment to the Senate banking bill proposed to cap at 5% the amount by which the interest rate could increase over the life of an adjustable rate mortgage (ARM) transaction. Recently, two Senate Subcommittees heard testimony on the subject of ARMs which included a review of underwriting standards, loan types, and consumer protections and disclosure requirements.

The CBA generally applauds the congressional concern accorded ARMs and recognizes that this form of mortgage lending has experienced certain problems in the early phases of its development. The CBA firmly believes, however, that significant progress has been made by both the industry and federal regulators in solving such problems. As a result, the CBA recommends that Congress should continue to monitor ARMs but should refrain from enacting any legislation on the subject. Legislation at this time, particularly of the restrictive kind considered last year, would only hurt the consumer as well as housing and mortgage lending trades during this period of resurgence in those industries.

Today, ARM concerns should be twofold. First and foremost is the concern over whether the current state of ARM lending is safe and beneficial for the consumer. The second concern should be to retain the greatest possible latitude for lenders who need flexibility in structuring loans.

ARM Developments

In 1981, the banking and thrift industries were suffering from disintermediation wrought by the inability of depository institutions to compete with money market

mutual funds that could offer savers market rates of return on their savings. Now, with the Garn-St Germain Act of 1982 completing the process started with the Depository Institutions Deregulation and Monetary Control Act of 1980, those institutions have deregulated liabilities.

As a result, banks and thrifts must create assets in their portfolios that will adjust with fluctuations in market conditions if the institutions are to remain viable in a deregulated environment. Thrift institutions in particular are the largest investors in mortgages. To restrict their ability to garner adjustable rate assets would pose serious problems for the future viability of an industry committed to support housing. Adjustable rate mortgages have been one of the ways that banks and thrifts have been able to cope with variable costs of funds and operating expenses, and they will continue to be a big part of the future.

In 1981, ARMs were essentially an academic issue. By and large, consumers were not willing to accept these loans, and the lending community had not learned how to develop ARMs attractive to consumers. As a result, lenders experimented with a variety of loan arrangements and standard products began to emerge.

In 1983 and 1984, the market developed ARMs at an astonishingly fast pace. Hundreds of different types of loans were devised and tested in this market. One basic measure of success has been the growing acceptance of ARMs by consumers.

This is due in part to the standardization of ARMs. That is, many of the ARMs today offer comparable features and options, so that the lists of products that ranged in the hundreds now are far fewer in number.

In an effort to document trends in ARM lending in the present marketplace, we are incorporating in our testimony the results of two 1984 membership surveys which were conducted by the National Council of Savings Institutions. The surveys were taken in June and December 1984 and were included in testimony before two Subcommittees of this Committee on April 19, 1985. /20

Of total mortgage originations during the second half of 1984, 73 percent were in the form of ARMs, while 22 percent were in the form of fixed-rate instruments.

20/ Hearings before the Subcommittee on Housing and Urban Affairs and the Subcommittee on Financial Institutions and Consumer Affairs, Committee on Banking, Housing and Urban Affairs, U.S. Senate, 99th Cong., 1st Sess. (April 19, 1985): Exhibits B through D.

These results mirror national trends -- the Federal Home Loan Bank Board reported that ARMs accounted for 70-75 percent of thrift originations during the second half of 1984, a slightly lower figure than during the first half of 1984.

A typical ARM offered by Council members was indexed to either the internal cost of funds to the institution or to one-year Treasury bills. For the most part, institutions relied on a single ARM per institution, with the most popular instrument accounting for 86 percent of originations. Thus, it appears that the early period of ARM experimentation is settling into the pattern of a single option per institution.

The majority of ARMs used by Council members included interest rate caps. These caps, averaging 2 percent per year and 6 percent over the life of the loan, were used in over four-fifths of originations. In comparison with the Council's June 1984 survey, the percentage of ARMs with interest rate caps increased by approximately 20 percent.

The December 1984 survey also revealed that the majority of institutions qualify ARM borrowers at the initial interest rate. The next most frequent qualifying measure was the maximum rate after one year -- typically

the initial rate plus two points. These results remain virtually unaltered from the previous survey.

The pattern of secondary market activity is also noteworthy in that the majority of fixed rate originations by Council members are sold, while most ARMs are kept in portfolio. For the second half of 1984, 77 percent of all fixed rate originations were sold in the secondary market, while only 40 percent of ARMs were sold.

Resolution of Potential Problems

The choice of a variety of instruments is important to both lenders and borrowers. Many borrowers have different needs that can be determined by income, job mobility, family structure and prospects for future income, to name but a few variables. It will help these consumers to have a range of choices as they approach their mortgage decisions. We are no longer in an environment in which one loan instrument can serve the market's needs.

In recognition of this, the marketplace and federal regulators have been quick to sense and address the special problems that the need for flexibility has engendered in this area of variable rate lending.

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One such problem has been consumer "payment shock." With adjustable rate mortgages, the danger is that borrowers will be confronted with increases in mortgage payments that they cannot meet. Payment shock can also be a problem when a mortgage starts at a significant discount from the rate established by the contractual index. In some of these situations, negative amortization can mean that a borrower's payment will increase even when interest rates in general do not.

Payment shock has been addressed at length by private mortgage insurers, the segment of the industry that stands to lose the most if consumers cannot maintain their loans. This industry insures investors against losses if mortgages fail, and that insurance increases the marketability of the loans in the secondary market.

One way the insurers have addressed the problem is through their reluctance to insure loans with annual payment increases of more than 15 percent. Private mortgage insurers have also worked to tighten the requirements on loans they will underwrite in order to minimize the risk of borrower default. MGIC, to name one company, revised its standards to limit to 3 percent the first-year discounted rate for ARMs. Thus, if a mortgage is priced at 2 1/2 points over the one-year Treasury bill index, for example 9.5 percent, the first year rate

charged to the borrower could not be below 9 percent, or 3 percent below the actual rate of 12 percent.

MGIC has also limited the amount of negative amortization, in loans they insure, to 125 percent of the original loan balance. This figure is generally accepted as a safe limit for all parties concerned.

Payment shock affects the portfolio lender as well. Problem loans mean that the lender is often going to lose money. First, as the loan becomes delinquent, charges incurred in servicing the mortgage must be assumed by the lender. Should problems continue, the portfolio lender must foreclose, often losing both principal and interest. If a loan program is not beneficial for the consumer, it will cause problems for the lender as well. Both lender and borrower are in the loan transaction together.

As a result, payment or interest rate caps are becoming more commonplace as borrowers and lenders appreciate the need to limit the risks they assume. It is typical to see a one or two percent annual interest rate increase and a 5 percent cap over the life of the loan. It is also common to find annual increase caps placed on payment levels.

Both the industry and the federal regulators are also addressing the need for adequate and uniform consumer disclosures. For example, various financial and housing trade groups, including CBA, worked with the Federal Reserve Board and the Federal Home Loan Bank Board to develop the recently published "Consumer Handbook on Adjustable Rate Mortgages."

Based on recommendations from the Federal Financial Institutions Examinations Council and its own analysis, on May 15, 1985, the Federal Reserve Board published a proposal to amend Regulation Z to provide more information to consumers about ARMs and to encourage uniformity of disclosure requirements among the federal agencies. The proposed changes would require creditors to make available to consumers descriptive material about adjustable rate mortgages (such as the Consumer Handbook on ARMs previously mentioned). The proposal would also require a more detailed description of the variable rate feature, along with a "bad case" example, at the time other Truth in Lending disclosures are given. The Fed proposal would also eliminate a provision of Regulation Z that currently permits creditors to substitute, for the Regulation Z information, disclosures specified by other federal regulations. This change is intended to foster a uniform set of federal ARM disclosures.

Disclosure and greater understanding of ARMs may also be assisted by the recent development of standardized ARM documents by Fannie Mae and Freddie Mac. This should further reduce the confusion that has resulted from a myriad of forms as well as different types of loans.

It is reasonable to conclude that the standardization process will continue, and more uniform and complete consumer safeguards will aid the consumer in making an informed decision.

Secondary Market Standardization

The progress towards standardization is also evidenced by secondary market developments concerning ARMs. Several of the large investment banking firms and other national mortgage market investors have been developing ARM mortgage-backed securities. Since securities of that kind require a large volume of a standard product for collateral, the growth of these mortgage-related investment vehicles will provide an increased impetus for uniformity in the market. Furthermore, investors in these securities want assurance that the loans will be stable, and therefore relatively safe for the borrower, in order to ensure successful payout and enhance investor acceptance.

The federal secondary market agencies, FNMA and FHLMC, have also taken important steps to address ARM problem areas. After initially buying a wide variety of ARMs, Fannie Mae, the largest agency purchaser of ARMs, limited the number of loan arrangements it will purchase, and has significantly tightened up its policies. Fannie Mae has now stated it will not purchase loans with an initial interest rate more than 2 1/2 percent below the fully indexed accrual rate. Fannie Mae offers important consumer-oriented options such as annual and life-of-loan interest rate caps.

Freddie Mac has also taken on the role of industry watchdog in its development of criteria for assessing insured loans. These underwriting guidelines set limits on payment increases, negative amortization, and borrower qualifications on all loans receiving private insurance, whether or not that loan is purchased by Freddie Mac.

In light of the many industry and regulatory efforts to address the problems associated with ARMs, CBA firmly believes that Congress should refrain from legislative action until the successes or shortcomings of these efforts are manifest. CBA suggests that these varied and creative responses may well solve congressional concerns in this area and should, therefore, be given a chance to work.

CREDIT DEREGULATION

Last year, this Committee considered the deregulation of state price controls that govern financial institutions and other creditors on business, agricul tural and consumer loans. CBA strongly supports legislation of this type and recommends that it be included in this year's deliberations.

Such legislation would further the deregulation of the cost of credit begun by the Depository Institution Deregulation and Monetary Control Act of 1980 (Act). Subject to certain exceptions, that Act permanently eliminated all interest rate ceilings applicable to first mortgage credit transactions and established a limited federal alternative to state interest rate ceilings for business and agricultural loans.

On the liability side, the Act provided for a six-year phase-out (effective March 1986) of federal restrictions on the amount of interest depository institutions could pay on their consumer deposits. The Depository Institutions Deregulation Committee (DIDC) was established to carry out this mandate.

Since 1980, DIDC has acted to achieve the goal of total deregulation of interest on deposits. It deregulated all time deposits of over thirty-one days in maturity. It required the phasing-out of minimum denomination requirements on Money Market Deposit and Super NOW Accounts.

With deregulation of the liability side of the balance sheet nearly complete, the ability of financial institutions to pay market rates to depositors has become dependent on similar flexibility in pricing mechanisms for credit products. The growth of variable rate lending exemplifies the attempt to "match assets" with the cost of funds and operating expenses incurred in originating and carrying those assets.

Price controls impede this essential flexibility and hamper the deregulation process. Further, price controls that were enacted to protect small and low-income borrowers from unscrupulous lenders have had unintended and adverse effects on borrowers, financial institutions, and the public, particularly during periods of inflation and contracted credit availability.

The volatile economic events of the recent past have clearly demonstrated that credit price controls only distort markets by having credit flow to deregulated

states, and thus do not serve the interests of consumers or borrowers. Current market stability does not obviate the need for legislation that would eliminate these cyclical problems.

Institutions with sufficient resources will continue to relocate certain credit operations to states such as Delaware and South Dakota that have enacted laws reflecting the demands of the marketplace. Financial institutions with more limited resources cannot afford to relocate. Those entities that operate in states with restrictive ceilings cannot price their loans to reflect accurately their costs of doing business, and are therefore forced to offer fewer products and services and less credit. Consumers are then hurt by price controls since they are unable to obtain credit.

Relocation by financial institutions affects the economies of the states with restrictive rate ceilings. Jobs and income are lost as institutions move to states that provide a more realistic financial environment. The interest of the public, the attraction of additional capital and new business, and the general employment situation are adversely affected by rate ceilings. The free flow of money between the states is biased toward states without rate restrictions since they provide an economic climate that encourages production.

Existing state price controls often differ dramatically depending on the type of loan and the type of institution that provides credit. This disparate treatment results in further inequality in the financial marketplace.

We believe that the increasing number of credit-granting institutions, coupled with the demands of the marketplace and increased consumer sophistication, will provide the controls necessary in the pricing of credit. Further, the recent substantial deregulation of liabilities makes the need to remove arbitrarily imposed asset limitations even more compelling.

We urge Congress, therefore, to enact legislation that provides a realistic response to the national problems caused by state-imposed price controls.

CONCLUSION

In conclusion, Mr. Chairman, we again urge you to act quickly to overhaul the obsolete and anti-competitive features of existing financial institutions law.

Geographic constraints have no place in today's truly national financial services economy. Limitations on bank products and services underscore the absence to

date of real deregulation in this industry. Legal innovations like non-bank banks pose less of a problem to the safety and soundness of the banking industry than the fact that statutes governing the industry have not been significantly revamped since they were put on the books 50 years ago.

Rather than increasing risk, deregulation will benefit consumers, enhance economic diversity, and promote competitive equity. We think it is important for the Congress to move boldly to deregulate the financial services industry and thereby assure the continued safety and soundness of our depository institutions.

The CHAIRMAN. Thank you, Mr. Stallkamp.
Mr. Edgerly.

STATEMENT OF WILLIAM S. EDGERLY, CHAIRMAN OF THE BOARD AND PRESIDENT, STATE STREET BANK & TRUST CO., BOSTON, MA, MEMBER, PAYMENT SYSTEM COMMITTEE, ASSOCIATION OF RESERVE CITY BANKERS

Mr. Chairman and members of the Committee, I am William S. Edgerly, Chairman and President of State Street Boston Corporation. I am appearing here on behalf of the Association of Reserve City Bankers, an association representing 150 of the nation's major banking institutions.

The Association of Reserve City Bankers has focused its attention on reducing risks in the nation's payments system. We have worked closely with the Federal Reserve Board to develop operating procedures aimed at controlling such risks.

In new legislation, we believe important weight should be given to the fact that unregulated companies will own depository institutions under any likely legislative outcome. Provisions should be included in any new legislation to offset the risks of such ownership.

We make no assertion that holding company regulation eliminates risk but only that it reduces it. Nor do we assert that all holding companies that are unregulated are risky. But for practical purposes,

there are just two classes of companies that will own depository institutions, regulated and unregulated.

Whether they are owned by regulated or unregulated companies or otherwise, all depository institutions have direct access to the Federal Reserve's electronic communications and settlement system, called FedWire. This was provided for by the 1980 Financial Institutions Deregulation and Monetary Control Act. FedWire handles over $330 billion in transactions daily and is growing at a 20% annual rate.

We recommend provisions in the new legislation that will shield FedWire and other related systems from unregulated risks. There are various ways to accomplish this. The basic approach is to provide for indirect rather than direct access to the payments system by unregulated companies. We are prepared to work with the Committee in its consideration of this important matter.

This concludes my prepared statement. I will be happy to respond to any questions you may have.

The CHAIRMAN. Thank you very much.
Mr. Stark.

STATEMENT OF MORGAN B. STARK, MANAGING DIRECTOR, CAPITAL MARKETS GROUP, CHEMICAL BANK, NEW YORK, NY, PRESIDENT, DEALER BANK ASSOCIATION

Mr. STARK. Mr. Chairman and members of the committee, good morning. I am Morgan Stark, managing director of the Capital Markets Group of Chemical Bank in New York. I appear before you today as president of the Dealer Bank Association, representing 176 commercial banks and their affiliates, of all sizes and from all parts of the country. We thank the committee for its invitation to testify.

The association supported the securities activities portions of S. 2851 in the last Congress and we appreciate the efforts of this committee, including particularly those of the chairman and the ranking minority member, in securing passage of the bill by the overwhelming vote of 89–5. We understand that the committee may consider a bill with similar securities provisions this year—in particular, municipal revenue bonds, commercial paper, mortgage-related securities, and mutual funds. We wholeheartedly support this approach.

The Senate has now three times passed legislation permitting banks to underwrite municipal revenue bonds. All of the pertinent Federal regulatory agencies have endorsed such legislation. The legislation is also supported by State and local governments across the country.

COMPETITION WOULD SAVE MILLIONS OF DOLLARS

There is a good public policy reason, of course, for this widespread support. Put simply, allowing banking organizations to underwrite and deal in municipal revenue bonds would save many millions of dollars for State and local governments and their taxpayers. Additional competition from banking organizations in the revenue bond market will reduce underwriting spreads by giving issuers more underwriters from which to choose. Additional competition from banking organizations will also increase the liquidity of the secondary market for revenue bonds. These savings for municipal governments can be achieved, I should add, without any increased cost to the Federal Government.

It is familiar history that revenue bonds were virtually nonexistent when the Glass-Steagall Act was passed, and that the absence of statutory authority for banks to underwrite and trade in all municipal revenue bonds is just an historical anomaly. Since 1933, Congress has amended Glass-Steagall at least 15 times to bring the benefits of bank competition to many issuers of public securities, including several international agencies. Surely our State and local governments should be allowed to receive those same benefits.

In preparing for today's testimony I was struck by what I consider to be a disturbing inconsistency. One of the 15 amendments to Glass-Steagall was to permit my bank as well as other banks across this country to underwrite revenue bonds as they relate to the Washington Metropolitan Area Transit Authority. We created com-

petition in price in the primary and secondary markets to bear on this particular opportunity. Under present law, however, I am restricted from competing in the same fashion as it would support roughly $1 billion in water revenue bonds which will be needed to support the city of New York.

This is, in reality, I would submit, not a large bank-small bank, urban-rural kind of issue, but rather an infrastructure issue as it relates to the country.

The commercial paper market is both enormous and highly concentrated. As of March 31, 1985, there was more commercial paper outstanding than there were commercial and industrial loans from commercial banks. Recent estimates are that two-thirds of the commercial paper market is in the hands of only two securities firms.

As this committee found last year, commercial paper has become a standard means for corporations to raise short-term funds. The paper is issued in large denominations to institutional and other sophisticated investors. It is, in practice, a substitute for bank loans—for the borrower—and bank deposits—for the investor. The conclusions the committee reached last year are still true: the evolution of our financial markets makes explicit authority for bank holding companies to underwrite and deal in commercial paper necessary for them to maintain their role as intermediaries in providing for the short-term credit needs of American business.

Permitting bank holding company subsidiaries to underwrite mortgage-related securities will enhance the efficiency and lower the costs of issuing those securities, and will help assure that mortgage money is available all across the country. America's present and future homeowners will be the beneficiaries of this increased competition.

Banks and the mortgage company subsidiaries of bank holding companies are significant originators of residential and commercial real estate loans. Although banks hold many of these loans for their own portfolios, they are also active in the secondary market, selling mortgages to institutional investors. Moreover, banks are explicitly permitted by existing law to underwrite, deal in, and purchase for their own account, obligations issued or guaranteed by Fannie Mae, Ginnie Mae, and Freddie Mac, which are federally created entities that issue securities on the basis of pools of mortgages.

S. 2851 did not include mutual fund authority. Secretary Baker, on behalf of the administration, has recommended that mutual fund authority be included in this year's bill. We support that recommendation. Banking organizations are today engaged in activities, including the provision of investment advice and the buying and selling of securities as agent, that give them the expertise and experience they need to compete effectively and safely in the mutual fund market.

Let me stress, Mr. Chairman, that the securities provisions of S. 2851, and the mutual fund authority recommended by the administration, constitute simply a natural and logical extension of services that banks have been providing for 50 years. Congress therefore can, and should, act promptly with respect to them.

While there are no broad Glass-Steagall issues before the committee at the moment, we urge the committee to move as soon as

possible toward consideration of the question whether the Glass-Steagall Act represents sound and sensible public policy under modern regulatory and market conditions. The association believes that the answer to that question will be no. For reasons described in my written statement, we believe that Glass-Steagall should be reformed to permit bank holding company subsidiaries to engage in all securities activities. In our view, reform of the Glass-Steagall Act would promote economic development and job creation in this country. It would strengthen banking institutions. And it would allow banking institutions to serve as financial intermediaries in a safe and efficient manner.

In conclusion, Mr. Chairman, the association commends your diligence and the efforts of this committee in attempting to persuade the Congress to deal constructively with the important issues presented by developments in the financial services marketplace. We urge the Congress to act, and to act soon, to permit banking organizations to compete in the municipal revenue bond, commercial paper, mortgage-related securities, and mutual fund portions of the capital market. We also believe that the time is ripe for the Congress to move toward consideration of the broad Glass-Steagall issues that are not raised by the limited set of activities presently before this committee.

Thank you. I will be happy to answer any questions you may have.

[The complete prepared statement follows:]

STATEMENT OF MORGAN B. STARK
ON BEHALF OF THE
DEALER BANK ASSOCIATION
BEFORE THE SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
JUNE 19, 1985

Mr. Chairman and Members of the Committee:

I am Morgan Stark, Managing Director of the Capital Markets Group of Chemical Bank in New York. I appear before you today as President of the Dealer Bank Association, a trade association of 176 commercial banks and their affiliates, of all sizes and from all parts of the country, that are active in the national and international securities markets. The Association appreciates the Committee's invitation to state its views on financial institution legislation.

ASSOCIATION SUPPORT FOR SENATE BILL

The Association supported the securities activities portions of S. 2851 in the last Congress, and we appreciate the efforts of this Committee, including particularly those of the Chairman and the Ranking Minority Member, in securing passage of the bill by the overwhelming vote of 89-5. We understand

that the Committee may consider a bill with similar securities provisions this year. We would wholeheartedly support this approach. It is clearly in the public interest for banking organizations to be allowed to compete immediately in the portions of the capital market opened up by last year's Senate bill, as the record of these hearings and last year's hearings demonstrates.

Municipal Revenue Bonds. As this Committee is well aware, the Association has long supported allowing banking organizations to underwrite and deal in municipal revenue bonds. The Senate has now three times passed legislation permitting banks to underwrite municipal revenue bonds. All of the pertinent federal regulatory agencies, including the Treasury, the Federal Reserve Board, the FDIC, and the Comptroller, have endorsed legislation that would permit banking organizations to compete in the revenue bond market. The legislation is also supported by state and local governments across the country, as well as by the associations that represent them in Washington.

There is a good public policy reason, of course, for this widespread support for permitting banking organizations to compete in the revenue bond market. Put simply, allowing banking organizations to underwrite and deal in municipal revenue

bonds would save many millions of dollars for state and local governments and their taxpayers. Additional competition from banking organizations in the revenue bond market will reduce underwriting spreads by giving issuers more underwriters to choose from. Additional competition from banking organizations will also increase the liquidity of the secondary market for revenue bonds. In these ways, additional competition will reduce the costs state and local governments must pay to borrow money.

These savings for municipal governments can be achieved, I should add, without any increased cost to the federal government. In an era of cutbacks in federal assistance programs for state and local governments, and when the infrastructure needs of our states and cities are great and growing, it is particularly important that Congress act immediately to remove the artificial barriers that now exist to full competition in the municipal revenue bond market.

It is familiar history that revenue bonds were virtually nonexistent when the Glass-Steagall Act was passed, and that the absence of statutory authority for banks to underwrite and trade in all municipal revenue bonds is just an historical anomaly. Since 1933, Congress has amended Glass-Steagall at least 15 times to bring the benefits of bank competition to

many issuers of public securities, including several international agencies (such as the Inter-American Development Bank). Surely our state and local governments should be allowed to receive those same benefits.

Commercial Paper. The commercial paper market is both enormous and highly concentrated. As of March 31, 1985, there was more commercial paper outstanding ($250.6 billion) than commercial and industrial loans by commercial banks ($246.2 billion). Recent estimates are that two-thirds of the commercial paper market is in the hands of two securities firms (Goldman Sachs and Merrill Lynch). This market, so close to the very heart of commercial banking, cries out for the additional competition that banking institutions could provide if permitted to participate in it fully.

As this Committee found last year, commercial paper has become a standard means for corporations to raise short-term funds. The paper is issued in large denominations to institutional and other sophisticated investors. It is, in practice, a substitute for bank loans (for the borrower) and bank deposits (for the investor). The conclusion the Committee reached last year is still true: "The evolution of our financial markets makes this explicit authority [for bank holding companies to underwrite and deal] with respect to

commercial paper useful if depository institutions are to maintain their role as intermediaries in providing for the short-term credit needs of American business."

Mortgage-Related Securities. Banks and the mortgage company subsidiaries of bank holding companies are significant originators of residential and commercial real estate loans. Although banks hold many of these loans for their own portfolios, they are also active in the secondary market, selling mortgages to institutional investors. Moreover, banks are explicitly permitted by existing law to underwrite, deal in, and purchase for their own account obligations issued or guaranteed by FNMA, GNMA, and FHLMC -- federally created entities that issue securities on the basis of pools of mortgages.

In recent years, the resources of the nation's capital market have been called upon to an increasing extent to provide the funds necessary to finance home ownership in this country. It is estimated that more than 17 million new households will be created in the next decade. To finance homes for these families, the nation's capital market will have to fund perhaps $1.5 trillion in mortgages -- one-half to three-fourths of which, it is estimated, will be financed through the sale of securities backed by pools of mortgages. Although 95 percent of the mortgage-backed obligations in the secondary market

today are issued by the three federally created agencies, the private mortgage-related securities market is growing very fast. Banks, thrifts and other mortgage lenders can increase the liquidity of their balance sheets by "securitizing" mortgage loans.

Permitting bank holding company subsidiaries to underwrite and deal in securities secured by pools of mortgages will enhance the efficiency and lower the costs of issuing mortgage-related securities, and will help assure that mortgage money is available all across the country. America's present and future homeowners will be the beneficiaries of this increased competition.

Mutual Funds. S. 2851 did not include the authority for bank holding company subsidiaries to sponsor, advise, and sell the shares of mutual funds. The Administration has recommended that mutual fund authority be included in this year's bill, and we support that recommendation. Mutual funds provide a way for individuals to invest in the American economy. There are situations in which a mutual fund is a more appropriate investment for a bank customer than any other product the bank can offer. Banking organizations are today engaged in activities, including the provision of investment advice and the buying and selling of securities as agent, that give them the

expertise and experience they need to compete effectively and safely in the mutual fund market.

Public Benefits. The public policy issues surrounding the securities activities before this Committee have been discussed and analyzed exhaustively. The record shows that allowing banking organizations to compete in these additional portions of the capital market will produce significant economic benefits to the public. More competition will bring lower costs and increased services -- as numerous economic studies show, and as common sense confirms. Banking organizations have long and productively and safely been major participants in many portions of the capital market, and they will use this experience to compete vigorously and fairly in additional portions of the market. Moreover, the requirement of a separately capitalized subsidiary for new securities activities, together with the other protective provisions of S. 2851, assures that there will be no undue risk to the bank, conflict of interest abuse, or tax or regulatory advantage when banking organizations compete.

For all these reasons, Mr. Chairman, the Association urges Congress to act -- and to act soon -- to permit banking organizations to compete in the municipal revenue bond, commercial paper, mortgage-related securities, and mutual fund portions of the capital market.

ASSOCIATION POSITION REGARDING THE GLASS-STEAGALL ACT

In our view, the securities provisions of S. 2851, and the mutual fund authority recommended by the Administration, constitute simply a natural and logical extension of services that banks have been providing for fifty years. As this Committee made clear in its Report on S. 2851, and in debate on the floor last year, these securities activities do not present any fundamental Glass-Steagall issues. Congress therefore can, and should, act promptly with respect to them.

In addition, Mr. Chairman, we urge the Congress to begin consideration, as soon as practicable, of the question whether the Glass-Steagall Act represents sound and sensible public policy under modern regulatory and market conditions. The Association believes that the answer to that question is "no." We believe that Glass-Steagall should be reformed to permit bank holding company subsidiaries to engage in all securities activities. In our view, reform of the Glass-Steagall Act would promote economic development and job creation in this country. It would strengthen banking institutions. And it would allow them to serve their role as financial intermediaries in a safe and efficient manner.

The Role Of Banking Organizations In The Capital Market. The Glass-Steagall Act is sometimes described as barring banks and their affiliates from engaging in the securities business. But that is a vast overstatement of what the Act does. In fact, banks and their affiliates are permitted by Glass-Steagall to engage in a wide variety of securities activities.

Banks underwrite and deal in billions -- actually, trillions -- of dollars of government securities, including not only Treasury securities but also the securities of the government-sponsored mortgage agencies and the securities of various international financial agencies. Banks underwrite and deal in billions of dollars of municipal securities, including revenue bonds issued for dormitory, housing and university purposes, as well as various specific transportation and other entities that Congress has specifically favored. Banks provide discount brokerage services to their individual and institutional customers -- a rapidly developing service that has helped bring down the cost for investors of buying and selling corporate stocks and bonds. Banks provide private placement services for their corporate customers, and give merger-and-acquisition advice. In Europe, bank holding company subsidiaries underwrite and deal in foreign government securities and in corporate stock and bonds -- including the stock and bonds of U.S. corporations.

The short of the matter is that banking organizations today have enormous experience and expertise in a very wide range of securities activities. The record shows that banks and their affiliates can and do engage in these activities in a safe and sound manner. No insured bank has ever failed on account of its securities activities or those of its affiliates. To the contrary, securities activities have provided a source of income that is not entirely dependent on interest rate spreads and have thereby increased the stability of the banking organizations as a whole.

While banking organizations have the human, technological, and financial resources to engage fully in the securities business, the Glass-Steagall Act prevents banks from doing so. That prohibition makes no sense today. It is contrary to the interests of consumers, investors, borrowers, state and local governments and their taxpayers, and all the many others that depend, directly or indirectly, on the capital market to finance their business or personal activities.

The Glass-Steagall Act Is Outdated. There is a powerful argument that the Glass-Steagall Act was based on a fundamental misapprehension by Congress in the 1930's about the nature of the securities activities of banks and the reasons for the bank failures of the 1920's, which were concentrated

among smaller, rural, undercapitalized banks. The argument is well-made in the economic literature, and in a paper we have provided the Committee entitled "Rethinking Glass-Steagall," prepared by J. P. Morgan & Co. But whatever may have been the case in 1933, it is clear that changes in the marketplace and in the regulatory structure make Glass-Steagall an anachronism today.

The developments in the marketplace in the last 50 years -- indeed, in the last five years -- have been enormous. Technological advances in particular have had the effect of linking the domestic and the international markets much more closely than ever before, and of merging the securities and the lending markets. There was a time when the roles of various market participants were well-defined: banks provided short-term, high-quality credit using deposits obtained at rates kept by law below market rates; securities firms provided longer-term credit by selling securities to investors that had a need for such securities. However, this has not been the case for years. Banks, for example, no longer have access to "cheap" deposits. Congress correctly decided that banks should pay market rates for deposits in competition with money-market funds, a development that was clearly in the consumer's interest. And securities firms have, quite appropriately, found ways -- such as underwriting commercial paper -- to serve the

short-term credit needs of the most highly qualified corporate customers of the banking system.

The market developments can perhaps best be described by an example -- one that is not entirely hypothetical. Suppose you are the treasurer of a major U.S. corporation that needs intermediate-term credit. You have many choices: a loan from domestic or foreign banks, insurance companies, pension funds or other institutional investors, or some combination of them through syndication or loan participation; the issuance of securities (bonds) in the U.S. by private placement or in a public offering; or the issuance of securities in the Euromarket. The bank with which you have dealt for many years can provide all of these services save one: the public issuance in the United States of corporate debt securities. This makes no economic sense for banking organizations or their customers in a world in which the securities and lending markets, domestic and international, are merging.

There have also been significant changes in the regulatory structure since Glass-Steagall was passed. Today we have in place a system of disclosure and enforcement that assures that the public has available all the material facts relating to securities that are offered to it. We also have federal and state regulatory agencies that examine banks and

their affiliates to assure compliance with laws and regulations against self-dealing or other improper actions. Finally, we have stringent and increasing capital requirements for banking institutions, far in excess of those required for other financial institutions. None of these sources of protecting the public interest existed when Glass-Steagall was passed.

In our view, the changes in the marketplace together with the changes in the regulatory structure have rendered the premises on which Glass-Steagall was built inapplicable today, even if they were valid 50 years ago.

The Glass-Steagall Act Is Anticompetitive. The fact that the Glass-Steagall Act is outdated may not be a compelling reason for Congress to change the law. But the fact that Glass-Steagall has insulated the major investment banks from competition in significant parts of the domestic capital market is a compelling reason to modify Glass-Steagall in a fundamental way.

The exclusion of banking organizations from certain sectors of the nation's capital market has resulted in less competition in those sectors than in the sectors in which banks can compete. For example, the ten leading underwriters in that part of the municipal revenue bond market from which Glass-

Steagall bars banks accounted for 58% of the market in 1984, while the ten leading underwriters in the municipal general obligation bond market (in which banks can compete under Glass-Steagall) accounted for only 39% of that market.

Another example is the Eurobond market, where U.S. bank holding companies can and do compete with securities firms in the underwriting of corporate debt securities. In Europe, the top five underwriters in 1984 held 49% of the market; while in the United States, where banking organizations are barred by Glass-Steagall, the top five underwriters of corporate debt securities held 75% of the market.

We think it is clear that the public would benefit from the dismantling of the Glass-Steagall barrier. As the Department of Justice said recently, the record shows that, where banks are allowed to compete against securities firms, the "increased competition . . . increases innovation and results in the offering of services at the lowest possible cost to consumers." Lower costs for raising capital will promote economic growth and job creation.

You will undoubtedly be told that there is plenty of competition in the securities business, even in those areas from which banking organizations are excluded. I do not think that in our system there is ever "enough" competition. In any

event, the facts show that the public would clearly benefit from more competition in the securities business. The Investment Dealer Digest reported that in 1984 "a handful of underwriters were monopolizing the market" and that the dominant firm, Salomon Brothers, had "cornered better than a quarter of the market." The enormous profits earned by securities firms show that additional competition can save money for investors and borrowers. After-tax return on equity for the ten largest securities firms has ranged from 17% to 30% from 1980 through 1984, far higher than the returns of banking organizations or most any other industry segment. And, in 1983, each of the 75 partners of one major privately-held investment banking firm (Goldman, Sachs) reportedly averaged $5 million in income; and each of more than 400 non-partners at that firm reportedly earned more than $200,000.

E. Erich Heinemann, the chief economist of Landenburg, Thalmann & Co., a New York securities firm, recently wrote that Glass-Steagall "has tended to limit competition -- for example, in the underwriting of corporate securities -- and to generate exceptional profits for those operating in protected sectors of the marketplace." More competition will eliminate the "protected" and "extraordinary" profits of a handful of investment bankers. More importantly, increased competition in the capital markets will make them even more

efficient and effective at performing the vital public service of putting capital to work for economic development.

The Argument Of Risk. Maintaining the safety and soundness of the nation's banking system is obviously a matter of great importance to this Committee and to the public. The safety and soundness of the banking system is a matter of concern to the Association as well, of course. We believe that allowing banking organizations to engage in a broader set of securities activities would strengthen the banking system, not endanger it.

Our view on this important point rests on two fundamental premises. First, securities underwriting and dealing activities involve only a limited set of risks that banks have successfully managed for many years. Second, securities underwriting and dealing activities will strengthen banking institutions, by diversifying their sources of income.

As I have previously noted, banks and their affiliates are today engaged in a wide variety of securities activities, including underwriting and dealing in government, municipal and certain other securities in the United States, and government and corporate securities abroad. The risks involved in underwriting these securities are of the same sort as the risks that Glass-Steagall is supposedly designed to

prevent banks from taking. Yet the record is very clear that banks and their affiliates have conducted their underwriting and dealing activities in a safe and sound manner -- and that they have continuously made money on their securities activities. If you look at the reported trading account net profits of each of the nation's ten largest banks for each of the last four years, for example, you will find that only one bank had a loss, and that loss occurred only in one year.

Thus, Congress need not guess whether it is too risky to allow banking organizations to engage in additional securities activities. It is clear from the historical record that banking organizations can and will conduct their securities activities in a way that contributes to their overall stability and profitability.

Contrary to some popular notions, studies show that underwriting corporate securities entails only a minimum amount of quite manageable risk. In the underwriting process, the underwriting syndicate buys securities from the issuer, and resells them to its customers, whose willingness to purchase the securities has previously been determined. As part of this process, the underwriter may hold the securities for just a few hours or days -- in sharp contrast to a bank that makes a loan to the same issuer, and that may have to hold that relatively

illiquid loan for years until it matures. As the 1983 Economic Report of the President concluded, "Glass-Steagall makes no important contribution to the protection of the public against bank failures."

Allowing banking organizations to engage in a wider variety of securities activities will also allow them to diversify their sources of income. Diversification will strengthen banking institutions in at least two ways. First, diversification will lower the institution's dependency on interest rate spreads to provide income -- a particular need in an age of volatile interest rates. Second, allowing banking organizations to underwrite and deal in a greater range of securities will reduce pressure to make riskier loans to generate income. This is an increasing problem as the most credit-worthy corporate borrowers are finding ways, such as commercial paper underwritten by securities firms and Rule 415 "shelf" offerings, to meet their financing needs without using bank loans. Exclusion of banking organizations from the corporate debt securities market therefore could result in a deterioration in the quality of bank assets -- contrary to Glass-Steagall's goal of enhancing the safety and soundness of banks.

Finally, Mr. Chairman, let me try to put the risk issue in its proper perspective. Banking fundamentally involves taking risks, because making loans is a risky business -- as anyone who ever loaned some money to his brother-in-law may know very well indeed. We cannot eliminate risk, and in a growing and vibrant economy we do not want to eliminate risk. We want banks and other financial intermediaries to manage risk: to understand fully what risks they are taking, to monitor the risks they have taken, to protect against risk by appropriate hedging and diversification, and to obtain a return that reflects the risk. Banking organizations that are well run manage their lending and securities underwriting and dealing risks in just this way -- and they will continue to do so after Glass-Steagall is revised.

The Argument Of Conflict. One of the most disingenuous arguments used by the securities industry in an effort to preserve its protected position under Glass-Steagall is that banking organizations have inherent conflicts of interest that should permanently bar them from greater participation in the nation's capital market.

The fact is that all diversified financial institutions have theoretical conflicts of interest growing out of their multiple activities. Many major non-bank financial

institutions perform a wide variety of activities that could give rise to the same set of conflicts as those to which bank holding companies are theoretically subject. For example, a diversified non-bank holding company, through its various subsidiaries can:

-- act as a fiduciary in managing other people's money;

-- act as a lender to corporations for any sort of commercial, real estate, or financial endeavor;

-- act as an investor in corporate and other securities, and as a purchaser of municipal bonds;

-- hold the public's money, and make it available on demand, through free cash balances from customers;

-- issue its own FSLIC - or FDIC - insured certificates of deposit if it owns a thrift or a non-bank bank;

-- and, of course, underwrite and deal in all manner of corporate and other securities in the United States.

We see no reason that companies like American Express or Merrill Lynch or Prudential Bache should not to be able to conduct all of these activities, despite the potential conflicts of interest that could arise from having one institution

play multiple financial roles. Indeed, we would urge the Congress to allow firms like these to own full-service banks in the United States. At the same time, we see no reason that bank holding companies should be barred from conducting these same activities under the same set of rules and regulations that govern the provision of these services by others.

The way to deal with potential conflicts of interest -- whether for a diversified financial institution or a bank holding company -- is to fashion a set of disclosure rules and substantive regulations that protects the public interest. In fact, we already have those rules and regulations in place.

For example, unlike the situation fifty years ago when Glass-Steagall was passed, we now require the issuer of corporate securities to tell the public investors what the proceeds of the issuance will be used for. Thus if an affiliate of the underwriter had made a loan that was to be repaid, the public would know -- and it would also know about any other material relationship between the issuer and any of the affiliates of the underwriter.

Aside from the securities disclosure rules, we also have in place a set of substantive regulations to govern the relationship between banks and their affiliates to protect the interest of their customers and the general public. For

example, under state and federal law a bank cannot buy securities for its trust accounts from an affiliate unless specifically authorized to do so. Existing federal law effectively prohibits the bank from loaning money to its securities affiliate. Existing federal law also prohibits anti-competitive "tie-ins" that might force a borrower to use other services of the bank or its affiliates. And regulation and examination by the Federal Reserve, the Comptroller of the Currency, and the FDIC protect against imprudent loans to corporate issuers and some of the other abuses that are said to have occured in the 1920's when the regulatory system was either non-existent or much weaker.

In short, the rules and regulations we have in place today to prevent conflict of interest abuse work. There is no evidence of any pattern of conflict of interest problems in either the banking or the securities business.

The public interest is also protected by the discipline of today's highly competitive marketplace. Any institution that abused its relationship with its customers or clients or correspondents would soon find its business lost to its competitors. Any institution that imprudently used its assets to aid its underwriting activities, or engaged in similar uneconomic actions, would soon find itself the subject of

intense regulatory scrutiny, media attention, or a class action lawsuit -- or all of the above.

For these reasons, the theoretical possibility of conflicts of interest arising from multiple roles does not justify an absolute prohibition against banking companies entering the securities business. The possibility of such conflicts does, of course, justify a set of disclosure rules and substantive regulations such as those now in place.

Finally, let me deal with the notion that there is something inherently inconsistent between the "promotional" activities of a securities firm and the advisory and other roles of a bank. The core point is that all successful banking institutions "promote" their products and services every day -- and in a competitive economy, that is exactly what we should do. The notion that if banking organizations could underwrite and deal in a greater range of securities they would somehow push their customers toward those securities ignores the realities of the competitive marketplace. Indeed, if there is a problem with banks trying to steer their customers to particular products, it exists now, for banking organizations have a limited set of products to offer. If banking organizations could also offer underwriting services to their corporate clients, and corporate stock to their customers, they would not

have the incentives they now have to encourage customers to take loans (rather than issue securities) or to make deposits (rather than make other investments).

The Need To Revise Glass-Steagall To Maintain Banking Institutions As Effective Financial Intermediaries. Technological advances and increased sophistication and expertise on the part of borrowers and investors have contributed to the merging of the securities and lending markets. This merger is driven by fundamental economic forces: it is more efficient (that is, cheaper) to meet the needs of many institutional borrowers and investors through securities than through the banking system. In simplified terms, when an intermediary can bring borrower and investor together through a security, the intermediary does not have to hold large amounts of assets and liabilities itself, and therefore requires less equity capital. This in turn reduces the amount the intermediary must earn to stay in business.

We are in the midst of this securitization of the lending markets. It started, as you are familiar, with commercial paper -- when high grade corporate issuers found it was cheaper to borrow short-term funds directly in the capital market than from banks. We have seen the development of private mortgage-related securities; that market has grown enormously

in recent years. We are now seeing additional forms of the same instruments -- the pooling of automobile loans is an example. We will see more in the future, including the securitization of other forms of consumer credit (like credit card receivables), as well as developments in the corporate credit area.

The implication of these developments for the banking industry, and for the public, is quite dramatic. As more and more of the best of the traditional bank borrowers find ways to tap directly into the capital market, banks could be left with a shrinking number of presumably less credit-worthy (that is, riskier) borrowers. Banking institutions will face the prospect of beginning to wither away -- as some economists think may happen -- or of making risker loans, or earning low returns on equity. There are other alternatives too: for example, I could imagine U.S. bank holding companies increasingly turning their attention to foreign markets, where they are permitted to compete in a greater array of products and services. This would mean serving both U.S. and foreign clients through the international, rather than the domestic, markets. That would not be a good development for the country.

Revision of the Glass-Steagall Act would permit bank holding companies to compete in the newly developing domestic

markets -- to play their essential role as financial intermediaries in a way that reflects the economic and technological realities of today's marketplace.

Glass-Steagall Should Be Fundamentally Reformed. For all these reasons, Mr. Chairman, the Association believes that Congress should revise the Glass-Steagall Act to permit bank holding company subsidiaries to engage in the United States in the full range of securities activities, including underwriting and dealing in corporate stocks and bonds. Let me make clear that we see this as very much a two-way street. We believe that any reform of Glass-Steagall should make clear that securities firms would be able to own full-service banks. All the customers of all these institutions -- corporate and individual -- will be well-served by the additional competition.

The proposal for a fundamental revision of Glass-Steagall is sometimes referred to as a deregulation proposal. That is terribly misleading. We do not suggest deregulation of the securities activities of banks or of the banking activities of securities firms. We do not suggest in the slightest a lessening of the investor protection provisions of the securities laws or of the depositor protections of the banking laws. What we are proposing is that the absolute prohibition of the Glass-Steagall Act be lifted for separately

capitalized bank holding company subsidiaries and that the public interest be protected instead by existing (and, if necessary, additional) regulation of the securities and banking activities of diversified financial institutions.

CONCLUSION

On behalf of the Association, I want to thank the Committee for the opportunity to testify today. We also want to commend you, Mr. Chairman, for your diligence and your patience in attempting to persuade the Congress to deal constructively with the important issues presented by developments in the financial services marketplace. We believe that the time has come for Congress to set the nation's public policy for financial institutions. For the reasons described here, we think that our public policy should be designed principally to promote additional competition among financial institutions under regulation that protects the public interest.

Thank you.

The CHAIRMAN. Thank you, Mr. Stark.
Mr. Roberts.

STATEMENT OF KENNETH L. ROBERTS, CHAIRMAN, FIRST AMERICAN CORP., NASHVILLE, TN, CHAIRMAN OF BANK HOLDING COMPANIES, ACCOMPANIED BY JOHN P. LaWARE, CHAIRMAN, SHAWMUT CORP., BOSTON, MA, CHAIRMAN-ELECT, ASSOCIATION OF BANK HOLDING COMPANIES

Mr. ROBERTS. Mr. Chairman and members of the committee, I am Kenneth L. Roberts, chairman of the board and chief executive officer of First American Corp. which, as Senator Sasser pointed out, is a regional bank holding company headquartered in Nashville, his hometown. I am also chairman of the Association of Bank Holding Companies, on whose behalf I am appearing today. I'm pleased to have with me my colleague, John P. LaWare, chairman of Shawmut Corp., and chairman-elect of the association.

Our association represents 180 bank holding companies which hold approximately 70 percent of all the commercial banking assets in the United States. We have members ranging in size from the National Banking Corp. of Florida with assets of just over $100 million to Bank America Corp. and Citicorp. All regions of the country are represented. First American, with $4.2 billion in assets, is typical of the association's membership. Our company owns seven banks serving Tennesee's major markets, and we also have affiliates engaged in such activities as investment advisory services and commercial finance.

We are one of those organizations which applied to the Federal Reserve Board for approval to establish limited purpose banks to make commercial loans in seven cities within our mid-South region. Obviously these applications are now being held in abeyance pending the outcome of certain court cases.

Mr. Chairman, last year our association testified before this committee on the need for bank holding companies to engage in additional insurance, real estate, and securities activities in order to remain viable competitors and better serve their communities. And our position in favor of additional products and services has not changed and we commend your continued leadership in this area.

INTERSTATE BANKING IS MAJOR TOPIC

Last year we did not address the topic of interstate banking because, as you know, the major banking trade associations had agreed that our emphasis should be on product and service legislation. But in view of the rapidly unfolding and, I say, historic events that are now occurring with respect to interstate banking, we believe it is timely to convey our views on that subject.

Mr. Chairman, we believe that interstate banking is the banking issue today. Never before has our industry faced such a confused and uncertain future, and the events of the past few weeks have lent an urgency to that matter that heretofore has been absent. We very much appreciate this opportunity to voice our viewpoints on this question.

As you know, on June 10, the U.S. States Supreme Court held that regional reciprocal interstate banking statutes were constitu-

tional, thereby eliminating the need for congressional sanction of such statutes. But that decision did not address the public policy issue of the need for a national policy to guide our industry into the evolution from a regional system to a national system. In point of fact, we believe that the Supreme Court decision has dramatically emphasized the critical need for a national interstate banking policy to eliminate confusion and inequities that now exist among State laws.

Our proposed solution is before this committee in the form of S. 1098, which has been introduced by Senator Cranston, and for which we are very grateful to the Senator for introducing that bill.

S. 1098 provides a 4-year phase-in period leading to nationwide interstate banking. It builds on the regional concept and then sets a clear path toward a date certain for nationwide banking, and it's this position which the Association of Bank Holding Cos., which after much debate, discussion, and canvassing of our whole membership, overwhelmingly voted to support.

The House Banking Committee on June 12 voted by a margin of 31 to 18 in favor of H.R. 2707, which was introduced by Chairman St Germain and 11 other members. That bill provides for a trigger, a date certain at which time national interstate banking would become legal. The date set is July 1, 1990.

To protect the rights of States, H.R. 2707 also provides the national trigger would only take effect in those States that enacted interstate banking statutes.

Although that compromise bill differs in details from S. 1098 which we prefer, our association endorsed H.R. 2707 and worked for it because it contained the essential provision of setting a date certain for national interstate banking.

These two historic actions, one with the Supreme Court and the other with the House Banking Committee, have sounded the call to action for the Congress to definitively determine what the Nation's banking system is to become. At this point, we believe that no action at all is the worst possible course. No response would leave the evolution of the Nation's banking system to the random actions of 50 States and various coalitions of States acting under provision of Federal law almost 30 years old.

We believe Congress must move ahead, using the House committee's bill and S. 1098 as models, to fashion a modern, competitive and fair banking system.

We agree with Chairman Volcker who told this committee on May 8, "The present situation of loophole exploitation and discriminatory regional arrangements is inherently unsatisfactory."

We are also pleased that last Thursday, Treasury Secretary Baker endorsed nationwide interstate banking along the lines of the House committee's bill.

Since 1980, some 36 States have enacted some type of interstate banking statutes, including my own State of Tennessee, and in my statement I have attached details illustrating the diversity.

Without going into that, Mr. Chairman, I submit to you, having reviewed these as a former lawyer, that it is a mass of confusion, a crazy-quilt pattern of inconsistencies and inequities. I submit that we have had three decades of congressional silence on this matter

and I think three decades are enough. We urge Congress to move ahead.

We believe that deliberate action now will result in a more modern, competitive, and fair banking system. And we also believe that failure to act will result in an ever-growing number of inequitable State laws and restrictive coalitions from which we will be unable to extricate ourselves. Meanwhile, our large nonbank competitors are moving aggressively across the country on a nationwide basis without this proscription.

Our association has always supported—indeed, we were the leader in advocating regional interstate banking, but we have always viewed it as a reasonable interim step toward full nationwide interstate banking; as a means, not an end in itself. And we do not support permanent regionalization or, as Chairman Volcker puts it, "the balkanization of banking."

INCREASED COMPETITION WILL BENEFIT CONSUMERS

Interstate banking in our view will strengthen and enhance the Nation's banking system and at the same time give consumers considerable benefits that result in increased competition.

In my statement there are citations from several reports which clearly demonstrate to us, and I think to anyone who reads them, that interstate banking does increase competition, does enhance the overall availability of credit, and does increase the competitive benefits to consumers, and the fact that organizations such as Consumer Federation of America and the Consumers Union are now issuing statements evidencing their belief in this fact is further support.

We applaud the efforts of the House Banking Committee and we applaud the efforts of your committee today and we encourage you to take advantage of the momentum that has now been created and to move expeditiously with constructive legislation.

Mr. Chairman and members of the committee, a Federal policy on the question of interstate banking is urgently needed. The opportunity is at hand to create a banking system that is fair and equitable to all banking organizations, regardless of their size, and regardless of their structure, and regardless of their location. And to do nothing, to choose a course of inaction, is to encourage confusion, inequality, and unfairness. I am convinced that this view, the necessity for national policy, is shared not only by our association membership, but by bankers large and small in every State in our Nation. Such a policy is in the public interest. It will contribute to a more healthy financial system. It will be one based on fair competition. It will not lead to the demise of community banks. It will be advantageous to consumers and it is in the spirit of free enterprise. I disagree with my friend and colleague, Walt Connolly, who says it's not too early. I think it's almost too late if we don't begin to deal with this issue now.

Thank you.

[The complete oral and prepared statement follow:]

ASSOCIATION of BANK HOLDING COMPANIES

Oral Statement
of
Kenneth L. Roberts
Chairman
Association of Bank Holding Companies
before
Committee on Banking, Housing and Urban Affairs
United States Senate
June 19, 1985

Mr. Chairman and members of the Committee, I am Kenneth L. Roberts, Chairman of the Board and Chief Executive Officer of First American Corporation, a regional bank holding company located in Nashville, Tennessee. I am also Chairman of the Association of Bank Holding Companies, on whose behalf I am appearing today. I am pleased to have with me today John P. LaWare, Chairman of the Shawmut Corporation, Boston, Massachusetts, and Chairman-elect of the Association.

Our Association represents approximately 180 bank holding companies which have about 70 percent of all commercial banking assets in the United States. We have members ranging in size from National Banking Corporation of Florida, with assets of just over $100 million, to BankAmerica Corporation and Citicorp. All regions of our country are represented. First American, with assets of $4.2 billion, is typical of the Association's membership.

First American owns seven banks serving Tennessee's major markets, and we also have affiliates engaged in such activities as investment advisory services and commercial finance. We have applied to the Federal Reserve Board for approval to establish limited-purpose banks to make commercial loans in Huntsville, Alabama; Greenville, South Carolina; Evansville, Indiana; Little Rock, Arkansas; Asheville, North Carolina; Jackson, Mississippi; and

Huntington, West Virginia. These applications are being held in abeyance pending the outcome of several court cases cited in my written statement.

Last year, Mr. Chairman, our Association testified before this Committee on the need for bank holding companies to engage in additional insurance, real estate and securities activities in order to remain viable competitors and better serve their communities. Our position in favor of additional products and services has not changed.

Last year, we did not address the topic of interstate banking because, as you know, the major banking trade associations had agreed that our emphases should be on product and service legislation. But, in view of the rapidly unfolding — and historic -- events occurring with respect to interstate banking, we believe it timely to convey our views on interstate banking.

Mr. Chairman, interstate banking is THE issue in banking today. Never before has our industry faced such a confused and uncertain future. The events of the past few weeks have lent an urgency to the matter that, heretofore, has been absent. We very much appreciate this opportunity to voice our opinions on the question.

As you know, on June 10 the U.S. Supreme Court held that regional reciprocal interstate banking statutes are constitutional, eliminating the need for a congressional sanction of such statutes. But that decision did not resolve the need for a national policy to transform our industry from a regional system to a national system. In point of fact, we believe the Supreme Court decision has dramatically emphasized the critical need for a national interstate banking policy to eliminate the confusion and inequities that now exist among state laws.

Our proposed solution is now before this Committee in the form of S. 1098, introduced by Senator Cranston, and we are grateful to Senator Cranston for introducing this bill. S. 1098 provides a four-year, phased in period

leading to nationwide interstate banking. It is this position we of the Association of Bank Holding Companies overwhelmingly support.

The House Banking Committee, on June 12, voted (by a vote of 31 - 18) in favor of H.R. 2707, introduced by Chairman St Germain and eleven other members. That bill provides for a "trigger" -- a date certain at which time national interstate banking would become legal. The date: July 1, 1990.

To protect the rights of states, H.R. 2707 also provides that the national "trigger" would only take effect in those states that enacted an interstate banking statute.

Although this compromise bill differs in details from S. 1098, we endorsed it because it contains the essential provision of setting a date certain for national interstate banking.

These two historic actions -- one by the Supreme Court and the other by the House Banking Committee -- have sounded the call to action for Congress to definitively determine what the nation's banking system is to become.

At this point, we believe that no action at all is the worst possible course. No response would leave the evolution of this nation's banking system to the random actions of 50 states, and various coalitions of states, acting under a provision of federal law almost 30 years old.

We believe Congress must move ahead, using the House Committee's bill and S. 1098 as models, to fashion a modern, competitive and fair banking system.

We agree with Chairman Volcker who told this Committee on May 8:

> "The present situation of loophole exploitation and discriminatory regional arrangements is inherently unsatisfactory."

We are pleased that just last Thursday, Treasury Secretary Baker also endorsed a "trigger," to nationwide interstate banking along the lines of the House Committee's bill.

Since 1980, some 30 states have enacted some type of interstate banking statutes. I have attached a table to my written statement that illustrates

their diversity. Thirteen states--Connecticut, Georgia, Utah, Florida, Massachusetts, North Carolina, Oregon, South Carolina, Idaho, Virginia, Maryland, Indiana and my own state of Tennessee--have adopted regional reciprocal statutes. Three states--Nevada, Rhode Island and Kentucky--have passed regional bills that will evolve into nationwide reciprocal arrangements. Two states--Alaska and Maine--now permit open entry by bank holding companies. Arizona will join Maine and Alaska in 1986, and Washington the year after. New York permits nationwide reciprocal banking.

Oregon permits unlimited entry from states in the 12th Federal Reserve District. Nine states--Delaware, Florida, Illinois, Iowa, Maryland, Nebraska, Nevada, South Dakota and Virginia--authorize out-of-state holding companies to operate limited purpose institutions such as credit card banks. Maryland has since amended this law to allow limited-purpose banks to be expanded into full-service banks.

We have had three decades of congressional silence on the matter, and, I respecfully submit that three decades are enough. We urge Congress to move ahead. Deliberate action now will result in a modern, competitive and fair banking system. Failure to act will result in an ever-growing labyrinth of inequitable and unfair state laws and restrictive coalitions from which we will be unable to extricate ourselves.

The Association of Bank Holding Companies has always supported, indeed, we have been the leaders in advocating, regional interstate banking. But we always have viewed it as a reasonable interim step toward full, nationwide interstate banking. We see it as a means, not the end in itself.

Interstate banking, in the view of our Association, will strengthen and enhance the nation's banking system, while, at the same time, give consumers the considerable benefits that result from increased competition.

The Bank Superintendent of the State of Maine (one of those states that permits open entry from bank holding companies anywhere in the country) in a

report released last January, said:

> "Banks which are a part of a financial institution holding company have experienced more rapid growth in loans. Those holding companies with out-of-state ownership have exceeded all other financial institutions in the lending area."

In a year's period ending June 30, 1984, loan growth in Maine's out-of-state holding companies was 30 percent, compared with 15 percent for companies controlled by in-state owners. And the residents and businesses of Maine were the beneficiaries of this increase in credit.

The February 15, 1985, edition of Economic Commentary, published by the Federal Reserve Bank of Cleveland, reported that in markets where more banks and other depository institutions were active, consumers benefited from higher rates on their savings deposits.

The conclusions that logically can be drawn from these and many other reports are that interstate banking will increase the overall availability of credit, and that it will increase competition to the great benefit of consumers.

Consumer advocates now are recognizing the benefits that will accrue from interstate banking, as evidenced by statements of support from such groups as the Consumer Federation of America and the Consumers' Union.

We of the Association of Bank Holding Companies applaud the accomplishments of the House Banking Committee. We also applaud the efforts of this Committee here today, and we encourage you to take advantage of the momentum that has been created and to move expeditiously with constructive legislation.

Mr. Chairman, and members of the Committee, a national policy on the question of interstate banking is urgently needed. The opportunity is at hand to create a banking system that is fair and equitable to all banking organizations, regardless of their size, structure or location.

To do nothing . . . to choose a course of inaction, is to encourage confusion, inequality and unfairness.

I am convinced that this view . . . the necessity for this national policy -- is shared not only by our Association's membership, but by bankers in every state in our nation.

Thank you.

ASSOCIATION of BANK HOLDING COMPANIES

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Kenneth L. Roberts
Chairman
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before
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June 19, 1985

Mr. Chairman and members of the Committee, I am Kenneth L. Roberts, Chairman of the Board and Chief Executive Officer of First American Corporation, a regional bank holding company headquartered in Nashville, Tennessee. I am also Chairman of the Association of Bank Holding Companies, on whose behalf I am appearing today. With me is John P. LaWare, Chairman of Shawmut Corporation, Boston, Massachusetts, and Chairman-Elect of the Association.

The Association of Bank Holding Companies consists of approximately 170 members whose combined assets comprise about 70 percent of all commercial banking assets. We have members in most states, ranging in size from National Banking Corporation of Florida, Inc., with assets of just over $100 million, to BankAmerica Corporation and Citicorp. First American, a banking organization serving America's mid-south states, is typical of the Association's membership. Our corporation owns seven banks serving Tennessee's major markets, and also has corporate affiliates engaged in investment advisory services, commercial finance, and credit life insurance underwriting. As of March 31, 1985, the corporation's assets totaled approximately $4.2 billion.

First American has applied to the Federal Reserve Board for approval to establish limited-purpose banks to make commercial loans in Huntsville,

Alabama; Greenville, South Carolina; Evansville, Indiana; Little Rock, Arkansas; Asheville, North Carolina; Jackson, Mississippi; and Huntington, West Virginia. The Board has postponed processing these applications, along with those of other bank holding companies, pending the outcome of several court cases.[1] In the meantime, we have opened loan production offices, which do not require such regulatory approval, in several of these locations.

Since the Association represents exclusively companies that are registered with the Federal Reserve Board as bank holding companies, our members reflect the unique viewpoint of the most closely-regulated set of institutions operating in the financial services area. By comparison, the companies with which we compete either enjoy much less stringent regulation and supervision or, in some cases, are essentially unregulated. The activities of our Association's members, on the contrary, are tightly controlled by the Bank Holding Company Act (Act) and by the dozens of regulations and interpretations that the Federal Reserve Board has issued in its 29-year administration of the Act. Altogether, the Act and the Board's administration have contributed to a banking system that is second to none in the world in terms of safety and soundness, fair competition, and consumer benefits. But fundamental changes are needed.

New products and services, and new technologies affecting delivery systems, are revolutionizing the financial services marketplace, creating an environment which is feeding the public's appetite for greater flexibility in this area. The downside of all of this creativity and activity is that the innovations are occurring piecemeal, leaving consumers with the difficult task

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[1] Dimension Financial Corp. et al v. Board of Governors, No. 84-1274, certiorari granted April 29, 1985; First Bancorporation v. Board of Governors, No. 84-1011, consolidated with Dimension case above; Florida Bankers Association, et al v. Board of Governors, No. 84-3269 (11th Cir., May 20, 1985); IBAA v. Conover, No. 84-1403 (U.S.D.C. - Fla., Feb.15, 1985) preliminary injunction issued by U.S. District Court for Middle District of Florida.

of sorting out how they should conduct their financial affairs amid all the clamor about new options. In all of this welter of products and services, sophisticated consumers can benefit, but the unwary can be harmed. Some resolution of the confusion is possible, however, without disturbing the advances that have occurred.

As Chairman Volcker indicated in his statement to the Committee on May 8, the Bank Holding Company Act represents the "overriding public interest in a strong, stable, and competitive financial system." And, as I note later on in this statement, the Act is the only statute where Congress has brought together all of the public policy concerns in a systematic manner. Congress can preserve this framework, while modernizing the law in order to provide bank holding companies the flexibility needed to serve consumers in the new marketplace. The fact is that bank holding companies today cannot serve their customers' expanding needs under the existing authority provided in the Act. As I hope I have made plain, the issue is not so much competitive equity as it is the overriding need of public policy to provide room for innovative products and services within a legal framework that will enhance a safe and sound banking system.

Judicial Moratorium

One fact that has emerged clearly in the last several weeks is that the court decisions cited in footnote 1 have created, in effect, a "moratorium" on "non-bank bank" applications. For the next six to twelve months, there will be no "flood" of such institutions released on America's towns and cities, as independent bankers have feared. Therefore, the crucial decisions Congress faces regarding the "bank" definition may now take place in a calm atmosphere, removed from any sense of impending crisis. Since ample time exists, this Committee has the opportunity to assess the longer-run, balancing the public policy objectives of enhancing the ability of consumers to obtain a broad

array of financial products and services against the necessity for retaining a safe and sound banking system.

Products and Services

The record of Congress, overall, has been mixed with regard to allowing depository institutions to expand the range of products and services they may offer their customers. It is relevant to note that congressional actions have had real effects: by and large they have broadened the authority of savings and loan associations and mutual savings banks while restricting the banking industry. The specific consequences can be seen in a report, dated April 1984, prepared by the staff of the House Banking Committee and entitled, "Comparison of Products and Powers of Selected Financial and NonFinancial Institutions." The report shows that today a unitary savings and loan holding company enjoys the greatest product flexibility afforded any depository institution. The institutions with the least flexibility, I am sorry to say, turn out to be bank holding companies.

Chairman Garn's bill (S. 2851) last year was a start toward dealing with the disparities revealed by the House Committee's report. Your bill, Mr. Chairman, even in the slimmed-down version that passed on September 13, 1984, thus represents the congressional high-water mark for banking asset deregulation.

Among other things, S. 2851 granted bank holding companies the authority to acquire thrift institutions and to establish "depository institution securities affiliates." The latter were separate subsidiaries in which bank holding companies could: (a) give advice to open-end investment companies; (b) deal in and underwrite revenue bonds; (c) deal in and underwrite mortgage-backed securities; and (d) deal in and underwrite commercial paper.

The limited scope of these additional powers is evident; we regret that S. 2851 could not have been more comprehensive. Still, Mr. Chairman, it was a

positive step, and we appreciate the support given it by the members of the Committee and by the full Senate.

In his prepared statement filed with the Committee on May 8, Chairman Volcker of the Federal Reserve Board noted that public policy should reflect concerns about fair competition, impartiality in the credit-granting process, and the safety of the banking system. In that context, he went on to recommend broadening the powers allowed bank holding companies. Specifically, Chairman Volcker included recommendations he made before this Committee on March 27, 1984. These were:

(1) insurance brokerage;
(2) real estate brokerage;
(3) home mortgage protection insurance underwriting;
(4) real estate title insurance underwriting;
(5) acquisition of S&L's;
(6) limited real estate development;
(7) sponsorship and distribution of mutual funds;
(8) underwriting revenue bonds; and
(9) underwriting mortgage-backed securities.

Chairman Volcker also said Congress may wish to review whether bank holding companies should be granted authority to conduct a full range of brokerage services. Overall, this is a forward-looking list of additional activities, and their authorization would go a long way toward helping bank holding companies meet the challenges posed by our competitors.

Competitors' Objections

Competitors of bank holding companies object to a number of the powers proposed for bank holding companies on several grounds. One is that they pose excessive risks for bank holding companies. Chairman Volcker, in his May 8 statement, noted that neither insurance brokerage nor real estate brokerage involve major issues of risk. He went on to say that the risks inherent in the other activities on his list were manageable.

Mr. Volcker's judgment is supported by an article in the May 1984 issue of the Economic Review published by the Federal Reserve Bank of Atlanta. The

authors, Larry D. Wall and Robert A. Eisenbeis, developed quantitative measurements showing that insurance and real estate brokerage are the least risky of all financial service activities, followed by banking. Operating an S&L was more risky, as was securities brokerage. Thus, several of the most controversial proposed activities cannot reasonably be opposed on the grounds of excessive risk to the holding company or its bank subsidiaries. On the contrary, the fee income generated by real estate and insurance sales, for example, would add to the profitability of the parent and in turn enable the parent to strengthen the resources of its bank subsidiaries. In short, congressional approval of the Fed's list would tend to increase the safety and soundness of the banking system.

A second assertion made by banking's competitors is that banks would engage in the practice of "tying." Practically speaking, "tying" can only succeed in an environment in which banks dominate a market. This situation rarely, if ever, exists today. On the contrary, conglomerates such as Sears, Prudential/Bache, and Merrill Lynch are competing with banks -- and "tying" products as fast as they can engineer the systems to permit it. It is difficult, therefore, to take this criticism against banking at face value.

Nevertheless, "tying" has been a persistent criticism. It led in 1970 to the enactment of a law making it illegal for a bank, or other subsidiary of a bank holding company, to engage in the practice of requiring a customer to purchase one product in order to obtain another. It has long been the Association's position that this statute, plus consumer protection measures such as a right of rescission, will virtually eliminate "tying" as an anti-competitive problem.

The firm of Chase, Brown and Blaxall, at our request, has prepared a definitive study of tying entitled, "The Role of Bundling in the Provision of Financial Services." This study concludes that "tying" can be a problem only

in a situation where there is a lack of competition existing for the "tied" products and when consumers lack the information they need to make adequate, informed decisions. Suitable amendments to the Truth in Lending Act can be drafted that will deal with any such problems that may occur.

As this Committee well knows, not everyone opposes bank product and services expansion. One of the most positive statements made to this Committee by any financial services industry official came from John G. McElwee, Chairman of John Hancock Mutual Life Insurance Company, who appeared on May 15. Mr. McElwee made the point that John Hancock must obtain banking authority in order to be able to meet the diversified needs of its customers. "If we are to hold ourselves out to consumers as a diversified financial services organization, then we must offer banking services . . . as well as insurance . . . securities brokerage . . . credit card . . . and real estate services," he said. In making this statement, Mr. McElwee recognized that reciprocal authority should be provided bank holding companies in these same areas.

One swallow does not make a summer, of course, and the reality is that Mr. McElwee undoubtedly represents a minority in his industry, but it is nonetheless encouraging that an industry leader of the stature of Mr. McElwee is prepared to speak out in favor of uniform powers. We look forward to more such positive statements emanating from other industry spokesmen.

Geographic Expansion

Although Congress has not yet enacted legislation allowing for interstate expansion by bank holding companies, the states have been moving forward. In fact, the regional banking provision in S. 2851, which appeared so advanced when it appeared last year, now is obsolete. The Supreme Court on June 10 upheld the constitutionality of regional laws the bill sought to affirm.

We were particularly pleased by the decision because an important part of the Association's overall interstate banking policy adopted in 1980 was a

recommendation for states to take advantage of section 3(d) of the Bank Holding Company Act (the Douglas amendment) and enact reciprocal interstate banking statutes, building on the experience of the State of Maine, at that time the only state to have acted in this regard. Seldom, if I may say so, has a trade association's recommendation produced such striking results. Since 1980, some 30 states have passed some type of interstate banking bill, and many others are considering doing so. The chief characteristic of these initiatives is their variety, as a glance at the table attached to my statement will indicate.

Thirteen states--Connecticut, Georgia, Utah, Florida, Massachusetts, North Carolina, Oregon, South Carolina, Idaho, Virginia, Maryland, Indiana, and my own state of Tennessee--have adopted regional reciprocal statutes. Three states--Nevada, Rhode Island, and Kentucky--have passed regional bills that will evolve into nationwide reciprocal arrangements. New York permits nationwide reciprocal banking. Two states--Alaska and Maine--now permit open entry by bank holding companies; Arizona will do so after October 1986, Washington will in two years. Oregon permits unlimited entry from states in the 12th Federal Reserve District. Nine states--Delaware, Florida, Illinois, Iowa, Maryland, Nebraska, Nevada, South Dakota, and Virginia--authorize out-of-state holding companies to operate limited-purpose institutions such as credit card banks. Maryland has since amended this law to allow limited-purpose banks to be expanded into full-service banks.

The Association has supported, indeed, our members have fomented, this activity at the state level. But we have always viewed it as an interim step toward nationwide banking. We have never regarded regional banking as an end in itself.

Regional banking laws viewed as permanent arrangements may create a false sense of security. The reality is that competitors for consumer deposits, loans, etc., will find ways to enter markets. As we have seen in Ohio and

Maryland, this can occur through failures of depository institutions, or simply through the outright purchase of thrifts by nonfinancial corporations. Moreover, the onrush of technology makes penetrating markets ever easier for companies possessing the technology. In our view, bankers who hope to survive by depending on the Maginot Line of regional banking laws are likely to be disappointed.

What is the appropriate congressional response? We will not be presumptuous and say we have the answer, but we are confident that our policy, now embodied in S. 1098 as introduced by Senator Cranston, represents a reasoned compromise among a representative cross-section of the nation's banking leaders.

The policy underlying S. 1098 was adopted at the Association's Annual Meeting in June 1984 in Newport, Rhode Island. At that time, it was endorsed by 87% of the membership present and voting, and followed approval, with one dissent, by the Board of Directors, and unanimous approval by the Legislative Policy Committee, of which I was Chairman at that time. Prior to these actions in Newport, we canvassed the entire membership to determine the views of each of our member companies. As such, then, the policy reflects an exhaustive process of eliciting member views, and reflects the overwhelming consensus of our membership.

Since Newport, we have been gratified by the response from other banking organizations. Several have endorsed it, including the California Clearing House Association and the California Bankers Association. Also, as you know, the American Bankers Association has adopted a policy that differs somewhat from ours, but nevertheless retains the essential principle of a date certain for nationwide banking.

The Association's policy contains the following elements:

(1) Effective upon enactment, congressional sanction would be given to legislation authorizing regional interstate banking arrangements;

(2) Effective two years after enactment, a bank holding company would be permitted to acquire other bank holding companies:

(a) in any contiguous state;
(b) in any state within the same federal reserve district as the acquiring bank holding company;
(c) if the home state of the holding company is part of two federal reserve bank districts, in any state within both districts; but
(d) "leapfrogging" would be prohibited; and

(3) Effective four years after enactment, a bank holding company would be permitted to acquire other bank holding companies anywhere in the country.

The phase-in to nationwide banking embodied in the Association's policy is designed as a compromise between the Association's largest members, who favor immediate nationwide banking, and many regional companies, which favor temporary regional banking arrangements as a means of positioning themselves for the advent of regional and nationwide banking. The policy calls for a move away from strictly regional arrangements in two years, with full interstate banking at the end of four years from the date of enactment.

One of the best analyses of regional and nationwide banking from the standpoint of individual states was done in 1983 for the Committee on Commerce of the Florida House of Representatives by Larry A. Frieder, Professor of Banking and Finance at Florida A&M University. Professor Frieder's paper concluded that, on balance:

> . . .the public interest is enhanced (by interstate banking) by the greater number of bank sites, broader product and service lines, and increased credit availability to businesses (of all sizes), consumers and municipalities. Small banks would not be endangered by interstate banking since they face no scale size disadvantage.[2]

Only nationwide interstate banking, Professor Frieder wrote, can provide Florida with the maximum diversity of competitors to benefit consumers and businesses in local markets. His conclusion was that a combination of a temporary regional banking arrangement with a nationwide "trigger" represented the best policy choice for Florida.

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[2] A summary of Professor Frieder's report appeared in the Autumn 1984 issue of Issues in Bank Regulation, published by the Bank Administration Institute.

Two concrete examples support Professor Frieder's analysis. First is a report prepared by the Bank Superintendent for the State of Maine, dated January 15, 1985. The Superintendent noted that ". . .banks which are part of a financial institution holding company have experienced a more rapid growth in loans. Those holding companies with out-of-state ownership have exceeded all other financial institutions in the lending area." In the year ended June 30, 1984, the Superintendent reported, loan growth of the State's holding companies controlled by out-of-state owners was 30%, compared to 15% for companies controlled by in-state owners.

Second, an article in the February 15, 1985, edition of Economic Commentary, published by the Federal Reserve Bank of Cleveland, reported that when more banks and other depository institutions are active in Ohio markets, consumers benefit from higher rates of interest paid on their savings deposits. If one can extrapolate from the two examples, we would argue that interstate banking as provided in S. 1098 promises to: (1) increase the supply of loanable funds in communities across the country; and (2) allow consumers to earn higher rates of interest on their savings deposits. It appears that consumer groups are beginning to recognize that the potential for public benefits does exist; we are now seeing expressions of support for interstate banking in statements by Consumer Federation of America and Consumers Union.

Also, of course, there is the statement of May 8 by Chairman Volcker to this Committee:

> The present situation of loophole exploitation and discriminatory regional arrangements is inherently unsatisfactory.

And just last Thursday, Treasury Secretary Baker said:

> Congress should turn its attention to the development of a trigger mechanism for nationwide interstate banking. The five-year trigger adopted by the House Banking (Committee) seems to me to be a reasonable time period for regional banks to make the transition to full interstate banking.

Some fear the demise of small banks if interstate banking proceeds. As Professor Frieder noted, there are no data suggesting that a small size bank faces inherent disadvantages in competing with larger institutions. The experience of New York State banks is a case in point.

Full branching throughout the State was authorized by the legislature more than ten years ago. This resulted in a march upstate by several large New York City banks, confident of being able to carve out a market share in the upstate markets. Some years later, the march forward turned into a retreat. The big banks found the competition presented by the smaller upstate banks to be far more formidable than they had anticipated. For their part, the smaller banks upstate learned that they had nothing to fear as long as they served their customers. The result was a healthy exercise in learning on the part of all of the institutions and managements involved.

Another concern voiced by opponents of increased bank competition is that the new entrants in local markets will siphon loanable funds to their headquarters, thus impoverishing local communities. This argument flies in the face of logic and experience. First, no bank holding company can afford to spend the money and management effort involved in an acquisition in a new market, and then turn its back on that community. To do so would mean that the bank that was just acquired would suffer along with the town. In fact, the efforts of managements such as First American go exactly in the opposite direction. We know that the community has to grow and prosper if our acquisition is to do well. So we support charity drives, education and the arts, industrial development, hospital improvements, and any other initiatives that hold out the promise of a better life for the citizens of the community.

Concrete evidence of this commitment appeared in the report I have already cited from the State of Maine, in which out-of-state bank holding companies had their Maine affiliates' loans grow by 30% in one year. This

means new money is available in Maine that would not otherwise be there. Similarly, when NCNB Corporation, Charlotte, North Carolina, acquired two bank holding companies in Florida, the loans on the books of those two Florida acquisitions rose by over $600 million. Again, that is credit Floridians did not previously have available. A third example is provided by Norwest Corporation, Minneapolis, which has reported that the loan-to-deposit ratios of Norwest's banks in the seven states in which it operates "are substantially above the state median in those states. . ." Again, that means more funds are being made available to consumers, businesses, and communities.

Mr. Chairman, there are other issues, such as concentration and safety and soundness, which I will not addresss. They have been addressed, however, in detail, in Chairman Volcker's May 8 statement. Suffice to say that, from the Association's point of view, valid public policy concerns can be met. They do not provide a basis for denying Americans the benefits that will flow from the increased competition that interstate banking offers. The 99th Congress has a unique opportunity to enact positive legislation in this area, and we believe it should not miss the opportunity.

The "Non-bank Bank" Issue

Part of the difficulty Congress faces in drafting a new definition of "bank" is that the issue has two sides. For bank holding companies, the "non-bank bank" is a vehicle for geographic expansion across state lines.

(As I mentioned earlier, First American currently has pending before the Federal Reserve Board seven such applications. Obviously, enactment of a bill along the lines of S. 1098 would be a far more desirable action by Congress, and would render moot the issue of "non-bank banks" as a geographic expansion device for bank holding companies. The Association would much prefer to see Congress do this.)

We believe no harm is done to the public by companies such as mine seeking to serve their markets better by opening limited-purpose banks in other states. The Association has always opposed the closing of the "non-bank bank" loophole by itself without simultaneous action by the Congress in authorizing interstate banking. The other side of the "non-bank bank" question, which involves the separation of banking from other lines of commerce, is of an entirely different nature. The Bank Holding Company Act was supposed to have maintained such a separation, but because of the way the definition of "bank" has been altered over the years, the stated objective has not been achieved. Congress today faces the question of whether securities firms, insurance companies, retailers, and the like should be allowed to own banks while not qualifying as bank holding companies.

It is relevant to note the fact that, under S. 2851, any company could operate a bank by keeping its commercial loan portfolio under ten percent of the "non-bank bank's" total assets (section 104(k)). Alternatively, a company could simply purchase the type of thrift institution that meets the rather loose "qualified thrift" test set forth in section 107 of S. 2851. The net result of the two exemptions seriously undercuts the policy of restoring the separation of banking and commerce. Chairman Volcker has suggested amendments to deal with these problems.

The same problems have shown up in prior congressional actions on the subject. In 1966, Congress enacted a change in the "bank" definition that exempted mutual savings banks. In 1982, a provision in the Garn-St Germain Act excluded institutions chartered by the Federal Home Loan Bank Board or insured by FSLIC. In retrospect, it is clear that in virtually every instance that Congress has altered the definition of "bank," it has done so to accommodate requests for exclusion by various types of institutions. All of these actions were viewed at the time as insignificant and

noncontroversial--the Federal Reserve Board, trade associations, and the relevant committees of Congress either were neutral or favored the exclusions. But the result today is a definition cut and pasted together in order to open, not close, loopholes.

The Association's members are well aware of this history. It has led us to be wary of proposals simply calling for the closing of "loopholes." As the battle in the House Banking Committee last week testified, it is politically difficult to enact meaningful legislation to deal with the "non-bank bank" question. This Association has consistently opposed loophole-closing efforts whose principal effect would have been to foreclose the use of "non-bank banks" by bank holding companies. The redefinition of "bank" now moving forward in the House does hold out the promise of meaningful change. We are encouraged by the progress being made, but we remain wary.

In considering the definition of "bank" anew in this Committee, it might be fruitful to address the question from the standpoint of how to equalize the burden of regulation and supervision among all companies selling financial products and services. In this regard, it seems to me there are three standards Congress should keep in mind: first, benefits to the public; second, safety and soundness of the financial system; and third, fair competition. As I mentioned earlier, the only place in the law where all of these concerns are focused in a systematic manner is the Bank Holding Company Act.

It is ironic, in view of this fact, that the Act today applies so narrowly. Owners of many banks and all thrifts are, as I have indicated, excluded. Thus Congress must decide if it wants public benefits explicitly to be required of a broader group of companies. Does it wish to require explicit assurances of safety and soundness? What about fair competition? If the answers are affirmative, then the definition of "bank" needs to be expanded to cover other owners of banks and similar depository institutions. If action is

not taken, it may not be long before a substantial share of all consumer financial services will be held by companies not regulated by the Act.

That is why, Mr. Chairman, a law that will uniformly regulate all companies offering bank-like products and services may make sense. Several of the proposals for modifying S. 2851 offered by Chairman Volcker move in this direction.

"South Dakota Loophole"

One of the major defects in S. 2851, as passed by the Senate, is the provision in section 104(d) known as the "Dodd Amendment." This would have prohibited state bank subsidiaries of bank holding companies from conducting any insurance activities not authorized by Title VI of the 1982 Garn-St Germain Act. We were disappointed that Senator Gorton's alternative to limit insurance activities only when out-of-state owners were involved failed on the Senate Floor on September 13, 1984.

This Committee now has the opportunity to revisit this issue, and we hope that, in so doing, it will not ignore the traditional rights of the states to determine the range of activities permissible for state-chartered banks. Some background may help.

Bank holding companies and their subsidiaries may engage in financial activities generally in two ways. First, they may conduct the activity in a "non-bank" subsidiary under section 4(c)(8) of the Act. These subsidiaries are limited by law to activities that are "closely related" to banking, and Title VI of the Garn-St Germain Act established statutory standards, pertaining only to insurance, that further restricts what the Board may allow in this area.

The second way bank holding companies may engage in financial activities is through their bank subsidiaries. In the case of a national bank subsidiary, it may do whatever is permitted by the National Bank Act and the

rules of the Comptroller of the Currency. In the case of a state-chartered bank, the type of activity has always been left to the discretion of each state. Over the years, some states have allowed state-chartered banks more latitude than national banks, others less. But the states have always decided the scope of the activities.

A controversy arose in March 1983, when the State of South Dakota's legislature enacted a bill giving state banks broad insurance powers and encouraging them to conduct insurance activities outside the state. Citicorp and BankAmerica Corporation filed applications with the Federal Reserve Board to purchase state-chartered banks in South Dakota, a step permitted by the South Dakota statute. These applications currently are pending before the Board and are, of course, perfectly legal.

Representatives of the insurance industry opposed the two applications at the Board and have been seeking congressional redress. Ironically, these same spokesmen also swear allegiance to the McCarran-Ferguson Act, which provides for regulation and supervision of the insurance business exclusively by the states. Nevertheless, the recommended solution for the "South Dakota problem" is for Congress to prohibit not only the exporting of insurance products and services by state-chartered banks, but also the conduct of any insurance activities within the states not now allowed under the Act for "non-bank" subsidiaries of bank holding companies.

This approach, reflected in the "Dodd Amendment," ignores the historical exercise of powers by the states over state banks. It would have the effect of eliminating the independence of the states to determine the scope of insurance activities of the banks they charter. A number of states besides South Dakota would be affected by this reversal of federal policy, while no case has been made of any threat to the public from the activities being curtailed. In fact, a strong case can be made that the public will benefit from such competition.

If this Committee believes that the insurance industry needs additional protection from bank competition beyond what Congress already has bestowed, then it should limit the damage to consumers by drafting an amendment which has as narrow an application as possible. We believe the authority for states to permit whatever activities they decide to allow should be retained. The "South Dakota problem," to the extent it is a problem, can be resolved simply by prohibiting the exporting of insurance products and services by state-chartered banks beyond the bounds of section 4(c)(8).

Improvements in Section 4(c)(8)

One of the most welcome features in S. 2851 from the Association's standpoint were the improvements made in section 4(c)(8) of the Act. Not only were they of value to bank holding companies, but they were incorporated into the bill, under the leadership of the Chairman and the ranking minority member, without controversy.

The changes were in two areas. First, language proposed by Senator Proxmire was added to the Act directing the Board to "take into account technological or other innovations in the provision of banking or banking-related services" in deciding whether to allow additional activities for bank holding companies. According to the report of the Committee, the change was intended "to ensure that the Federal Reserve Board considers the effect of technological and other changes in banking in administering the closely related test." While this change was modest, it was welcome, and will give the Board flexibility it does not now have.

The second improvement authorized by S. 2851 was in the applications process. The Committee, in its report, noted the present cumbersome nature of the procedures governing applications filed by bank holding companies. Rather than describe what the Committee did, I should like to quote from the Report:

> ...Under existing law, a bank holding company must file an application to engage in a nonbanking activity and await

Federal Reserve review and final action. Although designed to take 91 days, this process often takes longer and, if hearings are requested or court challenges are made by an opponent of an approved application, the process may take years to resolve. Contrasted with this are other corporate participants in the same nonbanking activities which may enter or leave these businesses without reference to any regulatory process.

In order to promote competition, facilitate bank holding company entry into permissible nonbanking activities, and ensure an adequate level of regulatory control over the process, section 104(d) of the bill provides for streamlined application and judicial review procedures (which are also applicable to securities activities under new section 4(c)(15)). These include a 60-day notice period after which a holding company would be authorized to engage in the permissible activity. The Federal Reserve Board is required to issue orders setting forth the reasons for any disapproval or determination not to disapprove a notice under section 4(c)(8). In addition, no notice would be required by a bank holding company for additional offices or changes of office locations for activities previously authorized for the same holding company.

I recognize that this is highly technical, yet it has significance for our members. The Federal Reserve Board has gone about as far as it can go under the law in simplifying procedures by regulation. Changes in the statute are needed to permit further changes, such as even the minor improvements described above.

We are glad that the Committee recognized the need for relief in this area, and we strongly urge inclusion of these provisions in this year's bill.

Conclusion

Mr. Chairman, and members of the Committee, clearly there are long-run problems confronting the financial services industry and Congress. Several of the key issues involving the long run are joined in the question of what is a "bank" under the Act. Congress needs to appreciate, as it grapples with this question, that the definition is of fundamental importance to banking's future.

Without minimizing this aspect of public policy, the Association believes there is an urgent need for Congress to enact legislation that will provide short-term benefits to bank holding companies, enabling them to better confront the competitive innovations that are flooding the financial services

marketplace. Basically, changes are needed in two areas: greater product and service authority; and relaxation of geographic barriers, including a date certain for full interstate banking. In addition, the non-controversial amendments in S. 2851 relating to section 4(c)(8) should be included in the Committee's bill.

The outlines of a constructive legislative package are clear, and we pledge to work with the Congress in an effort to achieve a satisfactory outcome in 1985.

Attachment

ASSOCIATION OF BANK HOLDING COMPANIES 6/17/86

STATE LAWS GOVERNING ACQUISITION OF DOMESTIC BANKS
BY OUT-OF-STATE BANK HOLDING COMPANIES

No Statutory Provisions	Express Prohibition	Permitted on Reciprocal Basis with Prior Approval	Permitted on Grandfathered Basis	Permitted with other Limitations	"Open" Entry Permitted
1. Alabama	1. Arkansas H.B. 196, §5E (1983)	1. Connecticut §83-411 (New England)	1. Florida* §656.29(d)	1. Delaware[3] Title 5, §803	1. Alaska[1] AS 06.05.235
2. California	2. Kansas §9-505a	2. Georgia §7-1-621 Eff. 1/84 to 7/85 (10 Southern Region States)	2. Illinois* §2510-3.07	2. Illinois*[4] §3.09	2. Maine[2] §1013.2
3. Colorado	3. Louisiana §1002.A		3. Iowa §524.1805	3. Maryland*[3,6] §5-901	3. Arizona Eff. 10/1/86
4. District of Columbia	4. Michigan §23.710 (130)(3)	3. Florida* §658.295 Eff. 7/85 (11 States & D.C.)	4. Nebraska* §8-902	4. Minnesota[5] §49.48	
5. Hawaii	5. Mississippi §81-7-19	4. Idaho Eff. 7/1/85 (6 Far West. States)		5. Nebraska*[3,4] L.B. 241 (1983)	
6. Montana	6. Missouri §362.925	5. Indiana Eff. 1/1/86 (Contiguous States)		6. Oregon[7] §716.920	
7. New Mexico	7. New Hampshire §384-B:IIV.	6. Kentucky Ch. 287 (Contiguous until 7/85, thereafter national)		7. South Dakota[3,6] §51-16-40	
8. North Dakota	8. New Jersey §17:9A-345	7. Maryland* (4 States first two years; 11 additional States thereafter)		8. Virginia* §6.1-390	
9. Ohio	9. Pennsylvania §115(b)(1)	8. Massachusetts Ch. 167A (New England)		9. Washington*[4] §30.04.230	
10. Oklahoma	10. West Virginia Art. 8AA, §31A-8A-1	9. Nevada (11 West. States; not Calif.)		10. Utah*[4] §7-19-2	
11. Texas		10. New York §142-b (National)			
12. Vermont		11. North Carolina §53-209 Eff. 7/86 (13 S. States & D.C.)			
13. Wisconsin		12. Oregon Eff. 6/1/86 (12th Fed. Res. Dist.)			
14. Wyoming		13. Rhode Island §19-30-1 (Regional Sunset 7/86 then national)			
		14. South Carolina §34-24-20 Eff. 7/86 (13 S. Reg. States & D.C.)			
		15. Tennessee Eff. 7/1/85 (14 State Region)			
		16. Utah* §9-1-102 (11 West. States; not Calif.)			
		17. Virginia* Eff. 7/1/85 (12 S. Reg. States & D.C.)			
		18. Washington Eff. 7/1/87 (National)			

1 Out-of-state bank holding company may not acquire a "recently formed bank" (as defined).
2 Out-of-state bank holding company must bring "net new funds" to state.
3 Out-of-state bank holding company may acquire a so-called "credit card bank" subject to various limitations.
4 Out-of-state bank holding company may acquire failing institution subject to certain restrictions. Under Utah statute, acquirer must be in Utah interstate banking region (11 Western states).
5 A failing mutual savings bank may be converted to a stock institution and then be acquired by an out-of-state bank holding company.
6 Out-of-state bank holding company may acquire a single bank, subject to limitations.
7 Out-of-state bank holding company may acquire a savings bank under exigent circumstances.

*Florida, Illinois, Maryland, Nebraska, Utah, Virginia and Washington are listed under two headings.

These classifications and footnotes are intended to serve only as aids to the reader in identifying the subject matter in the statutes. They may not be relied upon as authoritative interpretations.

The CHAIRMAN. Thank you.
Mr. Backlund.

STATEMENT OF B.F. BACKLUND, PRESIDENT, BARTONVILLE BANK, PEORIA, IL, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. BACKLUND. Mr. Chairman, members of the committee, I am Chip Backlund and I'm president of the Independent Bankers Association of America, representing 7,500 community banks. I am also president of the Bartonville Bank, which is a small community bank in the Peoria, IL, area.

In the interest of time, Mr. Chairman, I'm going to abbreviate even my abbreviated remarks because you have a written statement from us and this spells out our position very clearly.

As regards to the nonbank loophole, I do want to comment on the recent court decisions in this regard which have reminded us that the fundamental public policies underlying our banking laws can be changed only by the elected representatives of the people.

NONBANK BANK LOOPHOLE

Briefly, our position continues to be that a legislative closure of this loophole remains a very high priority. Our commitment has not been diminished by recent favorable court decisions.

Despite these outstanding victories that we've had, not only the one in Florida but the one in the Atlanta circuit court, the need for congressional action remains. For instance, there has not yet been a definitive judicial ruling that commercial enterprises like Sears may not acquire State-chartered nonbank banks.

IBAA finds itself in complete agreement with the ABA—I know some people may think this doesn't happen often, but it probably happens more than most people realize—we are in agreement with them regarding the specifics of the closing of the loophole. Ideally, no nonbank bank should be grandfathered. Certainly none should be grandfathered that were not up and running as of July 1, 1983. That's the date which Senator Garn and Senator Proxmire agreed to last year.

Furthermore, any grandfathered nonbank bank should be frozen both as to function and locations per their operating status as of the grandfather date.

Last, the job will not be complete unless attention is also paid to the so-called nonthrift thrifts. To this end, we enthusiastically endorse the restrictions recommended by Chairman Volcker.

In regard to interstate ownership of banks—and I say interstate ownership rather than interstate banking because interstate banking is a misnomer and we've had that certainly since Andrew Jackson—and of course, here we are absolutely opposed to Mr. Roberts' position.

Last week the Supreme Court removed all doubt as to the legality of regional banking laws. There is no longer any reason for Congress to speak on the subject of geographic expansion. Any congressional action would constitute an erosion of the authority of the sovereign States and the diminution of States rights.

OPPOSED TO NATIONAL TRIGGER

In particular, we vigorously oppose any legislation containing the so-called national trigger that would force any State opting for regional ownership of banks to open its borders to unrestricted interstate bank ownership.

And I might say that all the polls that I have seen taken of bank CEO's have shown overwhelmingly that they are against interstate ownership of banks. And I would say in regard to Mr. Roberts' remark that since we are going into regional banking, in a very heavy way in this country, apparently we need to wait and observe the effects of that concentration rather than going now toward nationwide ownership.

Furthermore, we also think that under the emergency interstate acquisition provisions of the 1982 Garn-St Germain Act that the money center banks should only be allowed to use the emergency acquisition provisions to buy one financial institution in one State rather than, as in the case of Citicorp where they have gone into four States already.

Nonetheless, IBAA is sensitive to the fact that in some States the largest banks do not exceed $500 million, making it impossible to find in-State bidders. The IBAA would acquiesce to amending title I of the Garn-St Germain Act by granting authority to all three Federal regulators, acting in unanimity and in concert with the State banking commissioner, to sell any of the four largest banks within an individual State when failing to qualified out-of-State bidders even if they fall below the $500 million threshold. Our staff discussed this with Chairman Isaac last week and he was in general agreement with the proposal.

Going on to deposit insurance reform, this is a subject we think should be addressed by this Congress. There is an obvious need to assure continued confidence in the deposit insurance system in today's less regulated environment. You must also address the serious inequities that now exist between almost all the Nation's commercial banks which are subject to the ultimate market discipline—that is they can fail—as compared to the dozen or more money center banks which are fail-safe.

There are other related issues on which in this regard we want to comment. First, IBAA is adamantly opposed to any merger of the FDIC and FSLIC and this may be the one issue, Mr. Chairman, on which all the Nation's banks could agree. The survival of the thrifts cannot be assured by the weakening of the banks' insurance funds and the impact of such a move could be very negative on public confidence in the banking system.

Second, we strongly urge the FDIC premiums be assessed upon the foreign branch deposits of U.S. banks at a rate equivalent to that level on domestic deposits. Senator Proxmire advanced this amendment, an amendment to this effect, last year and we hope you will be raising that proposal again.

FDIC Director Sprague strongly laid out the arguments for such treatment in a June 7 speech in Boston. Mr. Chairman, with your permission, I ask that Director Sprague's complete remarks which I have here be included in the record at this point.

The CHAIRMAN. Without objection, they will be.

[The speech of FDIC Director Irvine H. Sprague follows:]

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Director

FOR RELEASE ON DELIVERY
11:00 A.M., JUNE 7, 1985

NOTES FOR SPEECH AND PANEL DISCUSSION AT THE BOSTON UNIVERSITY SCHOOL OF LAW CONFERENCE ON "INSURING CONFIDENCE - DEPOSIT INSURANCE REFORM"

BY

IRVINE H. SPRAGUE
DIRECTOR
FEDERAL DEPOSIT INSURANCE CORPORATION

JUNE 7, 1985
MORIN CENTER FOR BANKING LAW STUDIES
BOSTON, MASSACHUSETTS

DEPOSIT INSURANCE REFORM

(It should be stated at the outset that the questions I pose and the comments I make represent my personal opinions as an FDIC Director, not policies formally adopted by our Board. I do know that the other two Directors agree with my concerns. Also, any numbers in this text are from publicly available sources.)

* * * * * *

Washington is blessed with an abundance of people who have all the answers to problems with our financial system, with the regulatory environment, and with the federal deposit insurance system.

There is just one difficulty: there seem to be as many answers as there are "experts."

Today, I take another approach. I pose to you some questions which bear on policies, laws or regulations not significantly changed in the FDIC's 52-year history.

Does the fact that off balance sheet items in the nation's 40 largest banks now exceed these banks' total book liabilities represent a problem?

Are capital standards that relate only to book assets and liabilities sufficient?

Should good banks pay the same rate of premium for insurance as troubled institutions?

Is it equitable that insurance premiums relate only to domestic deposits, which means all deposits for our smaller banks, but which constitute only a fraction of the exposure in the nation's multi-national banks?

ARE THE BIGGEST BANKS ASSURED OF A BAILOUT IF THEY GET IN TROUBLE, I.E., DO THEY HAVE DE FACTO 100 PERCENT INSURANCE? IF SO, ARE THEY PAYING AN ADEQUATE PREMIUM?

WHEN I FIRST CAME TO THE FDIC 17 YEARS AGO, IT WAS AN ARTICLE OF FAITH THAT BIG BANKS WERE BETTER MANAGED AND WERE, IN FACT, SUBSIDIZING THE SMALLER ONES BECAUSE A BIG BANK WOULD NEVER FAIL.

IS IT TIME FOR ANOTHER LOOK?

I AM NOT ALONE IN ASKING SOME OF THESE QUESTIONS. ON APRIL 29, 1985, THE THREE FDIC BOARD MEMBERS INSTRUCTED OUR STAFF TO UNDERTAKE AN INTENSIVE STUDY OF THE OFF BALANCE SHEET PHENOMENON. JOE SELBY, WHO IS ALSO HERE TODAY, A MEMBER OF OUR BOARD OF DIRECTORS AND ALSO ACTING AS COMPTROLLER OF THE CURRENCY, OFFERED TO COORDINATE SIMILAR STUDIES HE IS DOING WITH THOSE WE PROPOSED. THE FEDERAL RESERVE IS ALSO LOOKING AT THE PROBLEM.

THE BANKING INDUSTRY ITSELF IS BEGINNING TO STIR ON THE ISSUE. CARL REICHARDT, CHAIRMAN OF WELLS FARGO BANK, IS REPORTED IN THE MAY 8, 1985 AMERICAN BANKER, AS URGING BANKS TO TAKE A LEAD IN INCREASING THEIR OWN CAPITAL RATIOS TO PROVIDE A CUSHION FOR RISKY BUSINESS VENTURES WHICH MAY NOT BE REFLECTED ON THE BALANCE SHEET. HE NOTED THAT THERE HAS BEEN A SIGNIFICANT INCREASE IN SUCH OFF BALANCE SHEET ITEMS AS STANDBY LETTERS OF CREDIT, INTEREST RATE SWAPS AND LOAN SALES WITH RECOURSE.

IN TESTIMONY BEFORE THE HOUSE ENERGY AND COMMERCE SUBCOMMITTEE HEARING ON THE EXPANDING SECURITIES MARKET, PRESTON MARTIN, VICE CHAIRMAN OF THE FEDERAL RESERVE BOARD, EXPRESSED CONCERN FOR THE WAY THE BANKS ACCOUNT FOR LOAN SALE TRANSACTIONS. POOLS OF LOANS MAY BE SOLD WITH SOME RECOURSE TO THE ORIGINATING BANK IN CASE OF DEFAULT, BUT EVEN IF THE SELLING BANK REMOVES THE ASSETS FROM THE BALANCE SHEET, THERE REMAINS A CONTINUING LIABILITY.

IN A RECENT RULING, THE COMPTROLLER'S OFFICE ADDRESSED THIS PROBLEM BY REQUIRING CITIBANK TO KEEP ON ITS BALANCE SHEET ASSETS SOLD LAST YEAR BECAUSE THE SALE INCLUDED A RECOURSE AGREEMENT UNDER WHICH THE BANK RETAINED LIABILITY FOR 10 PERCENT OF ANY DEFAULTING LOANS IT HAD SOLD.

CARLETON R. HASWELL, A SENIOR VICE PRESIDENT AT CHEMICAL BANK, COMMENTING IN THE MAY 13, 1985 ISSUE OF FORTUNE, OBSERVED THAT EVEN IF BANKS LIMIT THEIR LETTERS OF CREDIT VOLUME TO THE GROWTH RATE OF THEIR LOANS, THE EXPOSURE WILL STILL BE SUBSTANTIAL BECAUSE MANY LETTERS OF CREDIT GUARANTEE PAYMENTS WELL INTO THE FUTURE.

WHILE THE ASSESSMENT RATE HAS BEEN ESSENTIALLY UNCHANGED IN STATUTORY AMOUNT SINCE OUR BEGINNING OVER 50 YEARS AGO, THE TOTAL LIABILITIES AND FUNDS GENERATION APPARATUS OF BANKS HAVE UNDERGONE SIGNIFICANT CHANGE. ONE EXAMPLE: DEPOSITS PAYABLE AT FOREIGN BRANCHES OF AMERICAN BANKS REPRESENT A MONEY-GATHERING MECHANISM WHOSE PROCEEDS, LIKE ANY OTHER

LIABILITY, CAN BE INVESTED IN ASSETS WHICH CAN LEAD TO PROBLEMS WHEN THEY DEPRECIATE IN VALUE. HOWEVER, THEY ENTIRELY ESCAPE THE DEPOSIT INSURANCE PREMIUM.

THIS CAUSES CERTAIN OBVIOUS INEQUITIES WHEN BANKS WHICH HAVE EXTENSIVE OVERSEAS BRANCHING OR UTILIZE OTHER LIABILITIES ARE COMPARED WITH BANKS WHICH RELY MORE ON DOMESTIC DEPOSITS.

FOR EXAMPLE, BOFA PAID US ALMOST $40 MILLION IN ASSESSMENTS IN 1984, WHEREAS CITIBANK PAID $18.5 MILLION. BOTH, IN MY OPINION, ENJOY DE FACTO 100 PERCENT INSURANCE PROTECTION BUT BOFA, WITH LESS TOTAL BOOK LIABILITIES, PAID MORE THAN TWICE AS MUCH IN INSURANCE ASSESSMENTS. NEITHER PAID IN PROPORTION TO THE ASSESSMENTS ON SMALLER BANKS WHICH RELY COMPLETELY ON DOMESTIC DEPOSITS.

TODD CONOVER FOUND HIMSELF IN HOT WATER BY TESTIFYING BEFORE THE CONGRESS THAT NONE OF THE TOP 11 BANKS WOULD EVER BE ALLOWED TO FAIL. HE SPENT THE NEXT TEN DAYS BACKPEDDLING.

HOPING TO AVOID THAT TRAP, I SIMPLY GIVE YOU: A FACT -- THE DEPOSITORS AND CREDITORS OF CONTINENTAL WERE BAILED OUT; A SURMISE -- NEITHER OF THE TOP TWO BANKS WOULD BE ALLOWED TO FAIL; A SPECULATION -- WHERE WOULD THE CUTOFF BE? HOW MANY OTHERS, IF ANY, WOULD NOT BE ALLOWED TO FAIL?

THE TREASURY DEPARTMENT STUDY ON FDIC REFORM ALSO TIP-TOES ON THIS POINT: "SOME HAVE BECOME SO LARGE THAT THE REGULATORY AUTHORITIES APPEAR UNWILLING TO ACCEPT THE DIRECT AND INDIRECT COST OF LETTING THEM FAIL IN THE CONVENTIONAL SENSE."

I AM NOT MAKING A PROPOSAL OR A PREDICTION -- I JUST WANT YOU TO THINK ABOUT THE QUESTION. WHAT IS FAIR? WHAT IS NECESSARY?

THE ASSESSMENT CHARGED BY THE FDIC TO ALL INSURED BANKS HAS BEEN EQUAL TO 1/12TH OF 1% OF DEPOSITS SINCE 1935. A PROVISION FOR A REBATE TO BANKS WAS ENACTED IN 1950. AFTER COVERING OUR OPERATING EXPENSES, OUR INSURANCE LOSSES, AND OUR PROVISIONS FOR ANTICIPATED FUTURE LOSSES, WE REFUND 60 PERCENT OF THE REMAINDER TO THE INSURED BANKS. GRANTED, THIS HAS NOT REPRESENTED TO BANKS A SIGNIFICANT RECAPTURE OF THE INSURANCE ASSESSMENT EXPENSE IN RECENT YEARS, BUT HISTORICALLY, IT HAD LED TO EFFECTIVE DEPOSIT INSURANCE RATES WELL BELOW THE STATUTORY AMOUNT -- 1/25TH TO 1/30TH OF 1% RATHER THAN THE STATUTORY LEVEL OF 1/12TH OF 1%. IN THE 1980'S, BECAUSE OF OUR HEAVY EXPENSES IN HANDLING FAILED BANKS, THE EFFECTIVE RATE IS ONLY SLIGHTLY LESS THAN THE STATUTORY RATE. FOR 1984, IT WILL BE BETWEEN 1/12TH AND 1/13TH OF 1%.

INSOFAR AS THE LARGER INSURED BANKS IN OUR NATION ARE CONCERNED, AT LEAST THOSE WITH DEPOSIT-GATHERING AT FOREIGN BRANCHES, THE EFFECTIVE ASSESSMENT RATE IS ACTUALLY LOWER, AS WE DO NOT COLLECT ANY INSURANCE ASSESSMENTS ON THESE FOREIGN DEPOSITS. THAT MAKES SOME SENSE. IF THE DEPOSIT IS PAYABLE SOLELY AT A FOREIGN OFFICE, IT IS NOT CONSIDERED AN INSURED DEPOSIT; HOWEVER, IF THESE FOREIGN DEPOSITS ARE LIABILITIES OF A VERY LARGE INSURED U.S. BANK THAT MIGHT NOT BE ALLOWED

TO FAIL, THEN TO THE EXTENT THAT INSTITUTION HAS PROBLEMS THAT REQUIRE FDIC FINANCIAL ASSISTANCE, EVEN THESE FOREIGN DEPOSITS, ALTHOUGH STATUTORILY UNINSURED, ARE PROTECTED.

TAKE THE CONTINENTAL ILLINOIS EXAMPLE.

ITS DECEMBER 31, 1983 REPORT OF CONDITION REFLECTED:

*/	ESTIMATED INSURED DEPOSITS	$4.5 BILLION
	OTHER DOMESTIC DEPOSITS	9.2 BILLION
	DEPOSIT BASE SUBJECT TO INSURANCE ASSESSMENT	$13.7 BILLION
	FOREIGN DEPOSITS	16.6 BILLION
	TOTAL DEPOSITS	$30.3 BILLION
	OTHER LIABILITIES	8.5 BILLION
	TOTAL BOOK LIABILITIES	$38.8 BILLION

*/ INSURED DEPOSITS WERE EXTRAPOLATED BASED ON 6/30/83 REPORTS, BUT BY THE TIME THE FDIC BECAME INVOLVED, INSURED DEPOSITS HAD DECLINED TO A LITTLE MORE THAN $3 BILLION.

CONTINENTAL, IN 1983, PAID ONLY THE BARGAIN BASEMENT ASSESSMENT OF $6.5 MILLION, BASED ON DOMESTIC DEPOSITS OF $13.7 BILLION, FOR ITS 100 PERCENT INSURANCE PROTECTION ON $69.1 BILLION IN ON AND OFF BOOK LIABILITIES.

THE LAW'S FAILURE TO COVER FOREIGN DEPOSITS IS A REFLECTION OF THE FACT THAT THIS WAS NOT A SIGNIFICANT CONSIDERATION IN THE 1930'S, WHEN FEW BANKS HAD FOREIGN BRANCHES OR FOREIGN DEPOSITS. THAT VIEW IS NO LONGER APPROPRIATE IN THE 1980'S.

WHEN THIS ISSUE WAS RAISED A FEW YEARS AGO, THE EFFECTIVE ASSESSMENT RATE WAS LESS THAN 1/25TH OF 1%. THE NEW YORK

BANKS ARGUED THAT IN ORDER TO BE COMPETITIVE OVERSEAS, THEY DESPERATELY NEEDED THE SUBSIDY PROVIDED BY NOT PAYING FOR INSURANCE ON FOREIGN DEPOSITS. THAT'S A MIGHTY THIN MARGIN.

SENATOR PROXMIRE HAS INTRODUCED LEGISLATION THAT WOULD REDUCE THE ASSESSMENT RATE ON DEPOSITS FROM 1/12TH TO 1/15TH OF 1% AND AT THE SAME TIME START ASSESSING FOREIGN DEPOSITS. THAT MIGHT BE ONE WAY OF CORRECTING THIS FOREIGN DEPOSIT LOOPHOLE. IT CERTAINLY DESERVES ATTENTION.

THE TREASURY DEPARTMENT AGREES THE IDEA HAS MERIT. THE ADMINISTRATION'S STUDY ON FDIC REFORMS ON PAGE 51 POINTS TO TWO OPTIONS: (A) AN INSURANCE SURCHARGE ON THE VERY LARGEST INSTITUTIONS, AND (B) A REQUIREMENT FOR INSURANCE PREMIUMS ON FOREIGN DEPOSITS.

TOM HEALEY IS WITH US TODAY. IT WAS HIS STUDY AND PERHAPS HE CAN ENLIGHTEN US FURTHER ON THE RELATIVE MERITS OF THESE TWO APPROACHES.

THE VOLUME OF FOREIGN OFFICE DEPOSITS ON WHICH NO INSURANCE PREMIUM IS PAID BY THE TEN BANKS WHICH LEAD IN BANKING ABROAD IS SHOWN IN THE FOLLOWING TABLE:

	December 31, 1984	
	Domestic Deposits	Foreign Deposits
	(In Billions of $)	
Citibank	30	49
Chase Manhattan	25	34
Bank of America	59	30
Morgan Guaranty	14	26
Manufacturers Hanover	23	22
Bankers Trust Company	9	19
First Chicago	12	14
Chemical Bank	22	13
Continental Illinois	8	8
Security Pacific	24	7
Totals	226	222

Quite apart from the foreign deposit question, we have recently found that certain bank liabilities -- standby letters of credit -- which do not appear on a bank's balance sheet, have been ruled, in the Philadelphia Gear case (Philadelphia Gear Corporation v. Federal Deposit Insurance Corporation, 751 F.2d 1131 (10th Cir. 1984)), to be insured deposits. We have requested the Solicitor General to file a petition for a writ of certiorari in the Supreme Court -- we may win, we may lose. We also have asked for Congressional action to rewrite our Act more specifically to make it clear that such contingent liabilities are not deposits.

In another recent case on deposit insurance for standby letters of credit, a U.S. District Court in Tennessee found for the plaintiff and against the FDIC. This case is also on appeal. Our brief was filed yesterday. But the trend in the courts is clear, so far.

If we were to accept the court findings and say that if a bank fails we will pay on these standby letters of credit up to the insurance limitation, then we would have to start collecting insurance assessments against these accounts. In addition, we would have to give consideration to the question of whether the FDIC should, as now permitted by our Act, collect insurance assessments on standby letters of credit for the previous five years as well.

As you know, standby letters of credit are not the only element in the expanding off balance sheet phenomenon. The press has carried articles recently about banker reaction to our capital regulation. It has been suggested that banks may be handling more income-producing activities off balance sheet so they do not need to support these activities with additional capital. In connection with this meeting, I looked at information on insured banks with more than $5 billion in deposits to see what the publicly available official Reports of Condition might disclose. What was extraordinarily interesting to me was the relationship between book liabilities and off balance sheet liabilities.

In the off balance sheet items disclosed in Schedule L on the Reports of Condition, one of the larger categories was loan commitments. Another large off balance sheet category has to do with foreign exchange transactions. Some of the other areas covered are activities involving note issuance facilities, securities lending and repurchasing activities, interest rate swaps, real estate investment and development, and sales of securities with bank assets as collateral. These activities represent only a few of the many that are not reflected on the balance sheet.

A caveat is called for at this point. As Bob Shumway, chief of our Division of Bank Supervision, points out, many nonbook liabilities are so contingent in nature that they can in no way be equated to book liabilities.

Let me share with you my preliminary thoughts arising from this review. There are over 40 insured banks with deposits in excess of $5 billion. In these institutions my staff found that, in the aggregate, insured deposits increased slightly as a percentage of total deposits from approximately 32% as of June 30, 1983, to approximately 34% on June 30, 1984. The raw data would suggest the insured deposit totals of these 40 institutions have increased from approximately $223 billion to approximately $262 billion. What is even more significant is the role being played by off balance sheet items. While acknowledging that Schedule L of the Report of Condition is

NEW -- REQUIRED ONLY SINCE 1983 -- AND PERHAPS NOT THE EASIEST TO COMPLETE, IT IS OUR ONLY CURRENTLY AVAILABLE METHOD OF DEVELOPING INFORMATION ABOUT THE VOLUME OF OFF BALANCE SHEET BUSINESS. THESE LARGE BANKS, WHICH HAVE INSURED DEPOSITS OF $262 BILLION, HAVE TOTAL DEPOSITS AND OTHER LIABILITIES OF $958 BILLION BUT EVEN THIS FIGURE IS LESS THAN THE $1.1 TRILLION THE SAME INSTITUTIONS REFLECT AS OFF BALANCE SHEET LIABILITIES. FOR THE 1983/1984 PERIOD MY STAFF LOOKED AT, INSURED DEPOSITS IN THE AGGREGATE REPRESENT SOMEWHERE BETWEEN 11% AND 13% OF THESE INSTITUTIONS' TOTAL OF BOOK AND NONBOOK LIABILITIES

I SHARE THIS INFORMATION WITH AN ALERT THAT IT IS RAW DATA. OUR STUDY OF THE OFF BALANCE SHEET PHENOMENON IS IN SUCH AN EARLY STAGE THAT NO CONCLUSIONS ARE PRUDENT. BUT IT IS NOT TOO SOON TO BEGIN THINKING ABOUT THE PROBLEM.

BY WAY OF SUMMARY, THE FEDERAL DEPOSIT INSURANCE SYSTEM IS APPROACHING ITS 52ND BIRTHDAY. LIKE ANYONE ELSE OR ANYTHING ELSE THAT IS 52 YEARS OLD, IT MAY BENEFIT FROM A MAJOR, OBJECTIVE OVERHAUL OF ITS STATUTE AND REGULATIONS.

JUST RECENTLY, OUR BOARD ASKED FOR PUBLIC COMMENT ON TWO PROPOSALS WE HAVE BEEN GIVING SOME THOUGHT TO. ONE IS TO RAISE THE MINIMUM ACCEPTABLE CAPITALIZATION LEVEL FROM 6% TO 9% BUT TO REQUIRE ONLY 6% OF THAT IN EQUITY. THE REMAINING 3% COULD BE EITHER IN EQUITY OR SOME KIND OF DEBT INSTRUMENT. A MAJOR PROBLEM WITH THIS PROPOSAL IS, OF COURSE, THE

FACT THAT THE THREE FEDERAL BANKING AGENCIES HAVE ONLY RECENTLY AGREED ON THE 6% CAPITAL LEVEL. CLEARLY, THE FDIC CANNOT ACT ALONE. I BELIEVE THAT ALL THE REGULATORS WOULD LIKE TO SEE MORE CAPITAL OVER TIME.

I WOULD ALSO ASK YOU WHETHER IT SEEMS REASONABLE THEN TO ESTABLISH OUR CAPITAL STANDARDS ON THE BASIS OF ONLY BOOK FIGURES WHEN WE KNOW THERE ARE SIGNIFICANT NONBOOK FIGURES JUST OFF THE BALANCE SHEET. SIX PERCENT CAPITAL IS SIX PERCENT OF WHAT?

WE ALSO ASKED FOR COMMENT ABOUT A PROPOSAL TO UTILIZE OUR DEPOSIT TRANSFER PROCEDURE IN THE CASE OF VIRTUALLY ALL BANK FAILURES. WE TESTED THE PROCEDURE WITH TWELVE MODIFIED PAYOFFS IN 1984, EIGHT OF WHICH HAD AN ADVANCE PAYMENT. IN THIS TYPE OF A TRANSACTION, INSURED ACCOUNTS ARE TRANSFERRED TO ANOTHER FDIC-INSURED INSTITUTION WHICH BIDS FOR THE DEPOSITS. WE THEN MAKE AN ESTIMATE OF THE PROJECTED RECOVERY THE UNINSURED DEPOSITORS AND OTHER CREDITORS MIGHT REASONABLY EXPECT, AND MAKE AN ADVANCE IN CURRENT VALUE DOLLARS OF APPROXIMATELY THAT AMOUNT RIGHT AFTER WE ARRANGE THE TRANSFER OF THE INSURED DEPOSITS. IF THIS PROPOSAL WERE TO BE ADOPTED IN EVERY BANK FAILURE, THE LARGE DEPOSITORS AND GENERAL CREDITORS COULD SUFFER SOME LOSS BUT IT WOULD HAVE FAR LESS EFFECT ON THE LOCAL COMMUNITY THAN A DEPOSIT PAYOFF OF ONLY THE INSURED AMOUNT.

THE PROBLEM WITH THIS APPROACH IS WE KNOW IN OUR HEARTS THAT IT WOULD NOT BE USED FOR A CITIBANK OR A BANK OF AMERICA. SHOULD WE USE IT FOR THE OTHERS?

IT SEEMS TO ME IMPROPER TO SUGGEST MAKING ANY KIND OF SIGNIFICANT OVERHAUL OF THE FEDERAL DEPOSIT INSURANCE SYSTEM FOR BANKS WITHOUT GIVING THOUGHT TO THE FEDERAL SAVINGS AND LOAN INSURANCE SYSTEM AS WELL. THERE SHOULD BE CONSISTENCY IN SUCH AREAS AS ACCOUNTING PROCEDURES, DISCLOSURE, AND CAPITAL REQUIREMENTS. I WILL LET ED GRAY TALK ABOUT THIS.

THE FDIC HAS SENT ITS OWN PROPOSED LEGISLATIVE PACKAGE TO THE HILL AND, IN ADDITION, A WORKING GROUP OF THE CABINET COUNCIL ON ECONOMIC AFFAIRS HAS MADE MANY RECOMMENDATIONS, AND THE BUSH TASK FORCE RECOMMENDATIONS MAY EVENTUALLY BE CONVERTED TO A LEGISLATIVE PROPOSAL. IT STRIKES ME THAT RICHARD BREEDEN HAS A PERPETUAL MOTION MACHINE IN ACTION ON THIS TASK.

A PERSONAL NOTE: IN NEARLY 11 YEARS ON THE FDIC BOARD, I HAVE PARTICIPATED IN HANDLING 268 FAILED OR FAILING BANKS REQUIRING FDIC OUTLAYS. THIS IS MORE THAN ANY FDIC CHAIRMAN OR DIRECTOR SINCE LEO CROWLEY, WHO WAS CHAIRMAN DURING THE TUMULTUOUS 1930'S. IN FACT, I HAVE WORKED ON ONE-THIRD OF ALL FAILED OR FAILING BANKS IN THE 50-PLUS YEARS THE CORPORATION HAS BEEN IN EXISTENCE. IN TERMS OF DOLLARS, THESE INSTITUTIONS REPRESENT SLIGHTLY MORE THAN 90 PERCENT OF THE DEPOSITS OF ALL THE FAILED OR ASSISTED BANKS IN FDIC HISTORY.

MANY OF THESE WERE EASY TO HANDLE, ALMOST BY FORMULA. SOME HAVE BEEN EXTRAORDINARILY COMPLICATED AND DIFFICULT.

I KNOW THE TRAUMA OF A FAILURE AND BELIEVE IN A STRONG REGULATORY ENVIRONMENT.

DEREGULATION CAME IN THE 1980'S AND WITH IT ALL OF THE ANTICIPATED RESULTS. AS VICE-CHAIRMAN OF THE DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE, I WAS PART OF THE PROCESS AND IN FACT PROVIDED THE MAJORITY VOTE ON SEVERAL CLOSELY CONTESTED ISSUES. WHEN DON REGAN BECAME CHAIRMAN, PAUL VOLCKER SUCCEEDED ME AS VICE-CHAIRMAN.

AS WE EXPECTED, INTEREST RATE DEREGULATION CONTRIBUTED TO BANK FAILURES, AS MANAGEMENT IN SOME INSTANCES SOUGHT TO GROW TOO FAST OR TOOK ON OVERLY RISKY ENDEAVORS ATTEMPTING TO COMPENSATE FOR THEIR INCREASED COST OF FUNDS. AFTER AVERAGING SIX FAILURES A YEAR IN THE DECADES OF THE 60'S AND 70'S, THE TOLL OF INSTITUTIONS REQUIRING FDIC OUTLAYS INCREASED TO 11 IN 1980, 10 IN 1981, AND REACHED 42 IN 1982, 48 IN 1983, 80 IN 1984 AND STANDS AT 43 AFTER THE FIRST FIVE MONTHS OF 1985.

THE CHALLENGE IS MATERIALLY DIFFERENT FROM THE TIME I LEFT THE FDIC BOARD OUT OF BOREDOM MORE THAN A DECADE AGO.

IN MY FIRST YEAR IN 1968, THE FDIC HAD THREE SMALL FAILURES TO HANDLE. IN 1972, WHEN I LEFT, THERE WAS JUST ONE FAILURE ALL YEAR -- A $20 MILLION INSTITUTION.

LAST FRIDAY, THERE WERE SEVEN FAILURES THAT WE HANDLED THROUGH THE WEEKEND.

SOME WILL TELL YOU THAT DEREGULATION HAD NOTHING TO DO WITH BANK FAILURES. IT, OF COURSE, HAS NOT BEEN THE ONLY

FACTOR. AS ALWAYS, BANK FAILURES ARE CAUSED BY FRAUD, GREED OR MISMANAGEMENT. INTEREST RATE DEREGULATION SIMPLY HAS PROVIDED AN ATMOSPHERE WHERE THESE FACTORS CAN FLOURISH. THE CLASSIC EXAMPLE IS MONEY BROKERING WHERE UNLIMITED FUNDS ARE OFFERED TO THE HIGHEST BIDDER, OFTEN TIMES TO ONE OF OUR BANKS WHICH SOON SHOWS UP ON THE FAILURE LIST.

THE ONE GOAL THAT CANNOT AFFORD TO BE OVERSHADOWED WHEN CONSIDERATION IS GIVEN TO ANY CHANGES IN THE FEDERAL DEPOSIT INSURANCE PROGRAM IS TO DO NOTHING THAT WILL DIMINISH THE STRENGTH AND REPUTATION ATTAINED BY THE SYSTEM SINCE THE MID-30'S.

THE FDIC LOGO IS THE SYMBOL OF CONFIDENCE AND WE MUST KEEP IT SO.

NONE OF THIS DISCUSSION RELATES TO ANY NEED FOR MORE MONEY FOR THE FDIC. WE HAVE PLENTY.

OUR INSURANCE FUND, WHEN I FIRST JOINED THE FDIC IN 1968, STOOD AT $3.7 BILLION. IT HAS GROWN STEADILY AND STRONGLY EVERY YEAR SINCE. IN 1979, WHEN I RETURNED AS CHAIRMAN FOR MY SECOND TERM ON THE BOARD, THE FUND WAS $8.8 BILLION. TODAY, MORE THAN SIX YEARS AND 242 BANK FAILURES LATER, THE FUND HAS RISEN TO $18 BILLION AND CONTINUES TO GROW.

AFTER ALL THIS, YOU ARE ENTITLED TO SOME CONCLUSIONS. I SUGGEST THAT WE START BY ASSESSING FOREIGN DEPOSITS AND USE THIS EXTRA INCOME TO CUT THE RATE FOR ALL BANKS.

AS THE PRESIDENT WOULD SAY IN ANOTHER CONTEXT: "THIS IS A REVENUE NEUTRAL PROPOSAL."

Mr. BACKLUND. Another matter I would say that it is important to avoid confusion among depositors, that only FDIC-insured institutions be called banks. I think that would clear up a lot of problems that we have.

So let us take this first major step now toward a more equitable insurance assessment base. Other proposals such as legislating a risk-based premium system should be considered in the near future. And a word of caution about the higher capital standards that are being pushed in certain quarters, if they are considered, it must be on the basis of risk assets, not on total assets. The mix of assets within individual banks varies tremendously.

In an era of interest rate deregulation and the consequent reduction of a bank's earning spread, it is important that insured depositories be accorded new means of generating income. This is commenting on the new products and services. But they should be consistent with safety and soundness considerations and the protection of the FDIC fund. Community bankers are particularly interested in brokerage powers for the sale of real estate, insurance, and securities. We feel that those powers raise few, if any, safety and soundness considerations.

On the South Dakota loophole, we believe that it is wrong when South Dakota undermines Federal law applicable to all the other 49 States in the name of job creation. We think it is equally wrong when the Federal Government seeks to tell South Dakota that it may not authorize State-chartered banks to exercise such powers solely within South Dakota, except when the States have authorized activities which Congress believes subject the FDIC to undue risk.

The critical focus of the Federal Government vis-a-vis State banks should be evaluation of risk, not whether the bank is affiliated with a holding company and, believe me, the name of the game of banking and the name of the game of banking regulation is evaluation and management of risk.

Briefly on electronic funds transfer, we believe that the time has come for Congress to legitimize interstate EFT systems under conditions which preserve delegated State control over deposit taking.

IBAA supports S. 1148, Senator Proxmire's Electronic Banking Equality Act, which would provide fairness and certainty in this area of the law. Enactment of S. 1148 would lift a legal cloud from EFT systems and permit their continued development in a manner which benefits consumers and treats all banks equitably within the context of State control over interstate deposit taking.

Before closing, the IBAA wishes to commend Senator Heinz, Senator Proxmire, and others for the sense of the Senate resolution they are planning to introduce regarding nonbank banks. But let me make our position clear. We do not view this resolution as a substitute for comprehensive legislation closing the nonbank bank loophole.

One personal note, I grew up on a farm in a small town in Nebraska. I was in the agribusiness before I became a bank examiner. I know how important those small community banks are out there in that agricultural economy. Two of the seven banks that failed a

couple weeks ago were banks that I examined several times during my history. Well-managed banks in those areas can get in a very weak position because of heavy loan losses and some of them have, and we urgently need a device to shore up these well-managed banks to have earnings projections, to work back to a strong capital position after they have suffered these losses.

The net worth certificate offers the best vehicle to do that. I urge you to give that very serious consideration. It's very important in those areas.

Mr. Chairman, that concludes my remarks and we are looking forward to participating fully in your upcoming consideration of the banking legislation and we hope you proceed with dispatch, but with caution. The problems banking is facing are not going to go away. Thank you.

[The complete prepared statement follows:]

TESTIMONY

OF

B.F. (CHIP) BACKLUND

PRESIDENT

BARTONVILLE BANK, PEORIA, ILLINOIS

AND

PRESIDENT

INDEPENDENT BANKERS ASSOCIATION OF AMERICA

WASHINGTON, DC

Before the

SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Concerning

FINANCIAL INSTITUTIONS LEGISLATION

JUNE 19, 1985

Mr. Chairman and members of the Committee, my name is Chip Backlund and I am President of the Independent Bankers Association of America (IBAA), a national trade association representing approximately 7500 commercial banks operating in forty-nine states and the District of Columbia. I am also President of the Bartonville Bank, a $36 million bank in Peoria, Illinois.

I am pleased to appear this morning to discuss IBAA's views regarding the need for, and scope of, financial institutions legislation. It is my understanding that the principal purpose of this hearing is to review what has transpired since last fall when the Senate passed S. 2851 by an 89-5 vote--legislation which IBAA supported throughout the legislative process.

The period since that deadlock has been marked primarily by some highly significant court decisions. Some were unpleasantly surprised by these rulings. IBAA was not, because there should be no surprise when the courts reaffirm the fundamental public policies underlying our banking laws. Those policies are the Congressional delegation of banking structure decisions to the individual sovereign states, and the separation of banking from general commerce. Those policies result in a diverse and highly competitive system of financial intermediaries responsive to the needs of consumers and to businesses of all sizes, without partiality. While IBAA sees

no reason to change those policies, the courts have reminded us that they can be changed only by the elected representatives of the people, not by unelected Administration officials.

In view of today's large panel and short time, I will focus on a few major priorities for IBAA. We look forward to reviewing the specific legislative proposals which we expect to be forthcoming soon from Chairman Garn and to participating in the process again when it moves beyond today's general oversight.

The Nonbank Bank Loophole

Legislative closure of the nonbank bank loophole remains IBAA's first and foremost legislative priority. Our commitment to this end has not been diminished by recent court decisions.

There is a considerable amount of misinformation regarding the present legal status of nonbank banks. Let me clarify matters.

First, a Federal District Judge in Jacksonville, Florida, in IBAA v. Conover, has issued a temporary injunction against the awarding of national bank charters. Although this case is not slated for trial until the fall, at the earliest, we are very confident of winning on the merits, given the

length and strength of the judge's agreement that we are likely to prevail in our contention that nonbank banks can not engage in the "business of banking" required of national banks because they cannot serve as full service intermediaries to commercial banks--that they are, in fact, a new type of bank which has not been authorized by Congress.

Assuming we do prevail, any appeal by the OCC will go to the same U.S. Court of Appeals in Atlanta which recently reversed the Federal Reserve in Florida Bankers Association v. Board of Governors. Under that ruling, bank holding companies may not acquire nonbank banks, regardless of whether they have state or national bank charters.

Despite these outstanding victories against the backdoor repeal of the Bank Holding Company Act by the Comptroller's chartering of and the Fed's acquiescence in such chartering of nonbank banks, the need for Congressional action remains. First, although the logic of these cases would seem to doom all nonbank banks, there has not yet been a definitive judicial ruling that commercial enterprises like Sears may not acquire state chartered nonbank banks. Also, the Eleventh Circuit decision in Florida Bankers Association v. Board of Governors is in conflict with some portions of the Tenth Circuit's Dimension ruling, a case which has been accepted for review by the Supreme Court. Although the sensitivity and

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appreciation of the Court to America's locally based banking system was amply demonstrated in last week's regional banking decision, and should result in it siding with the Atlanta panel rather than Denver, it would nonetheless be desirable and appropriate for the Congress to reassert its policy-making primacy and to give legislative expression to its broad and nonpartisan consensus that nonbank banks should be firmly and finally outlawed.

IBAA finds itself in complete conformity with the ABA as regards the specifics of closing the loophole. A "bank," for Bank Holding Company Act purposes, should be defined as any institution insured by the FDIC, as well as any other institution which accepts transaction accounts and makes commercial loans. It would also be desirable to include all institutions eligible for FDIC insurance. In turn, only an FDIC-insured institution should be allowed to use the name "bank."

Ideally, given the mounting judicial identification of nonbank banks as illicit legal fictions, none should be grandfathered. Should that well deserved excommunication prove politically impossible, then certainly none should be grandfathered that was not up and running as of July 1, 1983; a date which Chairman Garn and Senator Proxmire, among others, cited early and often as the outer demarcation of any such

leniency. Any grandfathered nonbank banks should be frozen, both as to functions and location, per their operating status as of the grandfather date.

While the end of the nonbank bank is clearly in view, the job of preventing loophole-threading evasions of basic public policies will not be complete unless attention is also paid to so-called nonthrift thrifts. To this end, we enthusiastically endorse the recommendations of the Federal Reserve Board for assuring that thrifts controlled within a unitary holding company are primarily oriented toward housing finance and are operated in a manner which prevents undesirable and anticompetitive interminglings of banking and commerce.

Interstate Ownership of Banks

In the last Congress, IBAA supported S.2851 despite its inclusion of a title sanctioning state-enacted regional banking laws. We took this position for two reasons. First, S.2851 was, on balance, a positive legislative package for the banking industry. Second, while IBAA does not support any form of interstate corporate bank ownership and deposit-taking, we felt that Title X did little more than restate what the law already was--that Congress, in the Douglas Amendment, had delegated sweeping authority to the states on the question of interstate banking. Further, in no way did Title X exert coercion on any

state to take any action permitting broader interstate ownership of banks.

As we know, last week the Supreme Court removed all doubt as to the legality of regional banking laws. Given that event, there is no longer any reason for Congress to speak on this subject. Any Congressional action would constitute an erosion of the authority of the sovereign states on this subject, a diminution of states' rights which IBAA would vigorously oppose as detrimental to the dual banking system and the soundness of the banking structure. In particular, IBAA would strongly oppose any legislation containing a so-called national trigger that would force any state opting for reciprocal regional arrangements to open its borders to unrestricted bank acquisitions.

As a final comment on the subject of interstate bank ownership, we note that the emergency interstate acquisition provisions of the Garn/St Germain Act expire this October. We would be strongly opposed to any drastic changes in this law which generally has been administered responsibly. We recommend that the law be tightened to limit emergency out-of-state acquisitions to one for any out-of-state bank or bank holding company. In the future, money center banks should <u>not</u> be allowed to use these emergency acquisition provisions to buy financial institutions in two, three, or four states as

Citicorp already has.

However, the IBAA is sensitive to the fact that there are states where the larger banks in the state may not exceed $500 million. In such states, finding an in-state bidder or exercising the option of breaking up one of these larger banks and selling it in-state may not be possible. Since the regulators conceivably could find themselves with such an emergency situation on their hands over the next two years, the IBAA would not oppose amending Title I of the Garn-St Germain Act by giving the authority to all three federal regulators, acting in unanimity and in concert with the state banking commissioner, the option of selling any of the four largest banks in any state, should they be failing, to qualified out-of-state bidders. This flexibility could be accorded the regulators while keeping the $500 million threshold level in place for all except the four largest banks in any state. This provision must be carefully circumscribed to insure that it does not lead to another end run on the Douglas Amendment if it were exercised by an inappropriately aggressive regulator. And I hope that this Committee feels strongly, as we do, that the failure of a $10 million bank in Nebraska or $475 million bank in Illinois for which there is no in-state bidder, should not be the vehicle for the out-of-state auction of this bank to the highest bidder.

Deposit Insurance Reform

The subject of deposit insurance reform is one which IBAA believes should be addressed immediately by the Congress. There is an obvious need to assure continued confidence in the deposit insurance system in this less regulated environment. There is also need to redress the serious inequity that now exists between almost all the nation's commercial banks that are subject to ultimate market discipline--that is, failure--and the dozen or more money center banks which are fail-safe.

There are two issues related to the deposit insurance system on which we do want to go on the record now.

The first is the proposal to merge the FDIC and FSLIC insurance funds. IBAA is adamantly opposed to such a merger. So long as thrifts are subject to fundamentally different regulatory, accounting, and capital standards than banks, it would be most unwise to tap into the reservoir of safety for our depositors that has been funded by the commercial banking system. The survival of the thrifts cannot be assured by weakening the banks' insurance fund.

Second, we strongly urge that FDIC premiums be assessed

upon the foreign branch deposits of U.S. banks, at a rate equivalent to that levied on domestic deposits. Senator Proxmire advanced an amendment to this effect last year, and we understand that he will be raising that proposal again. FDIC Director Sprague laid out the arguments for such treatment in a June 7 speech in Boston, in which he stated:

> "Deposits payable at foreign branches of American banks represent a money-gathering mechanism whose proceeds, like any other liability, can be invested in assets which can lead to problems when they depreciate in value. However, they entirely escape the deposit insurance premium.
>
> "This causes certain obvious inequities when banks which have extensive overseas branching or utilize other liabilities are compared with banks which rely on domestic deposits...Insofar as the larger insured banks in our nation are concerned, at least those with deposit-gathering at foreign branches, the effective assessment rate is actually lower, as we do not collect any insurance assessment on these foreign deposits... Continental (Illinois), in 1983, paid only the

> bargain basement assessment of $6.5 million, based on domestic deposits of $13.7 billion, for its 100 percent insurance protection on $69.1 billion in on and off book liabilities... I suggest that we start by assessing foreign deposits and use this extra income to cut the rate for all banks."

Let us take this first major step towards a more equitable insurance assessment base now. Other issues such as moving towards a risk-based premium system, which we support, may not be as ready for prompt legislative consideration.

New Products and Services for Bank Holding Companies

In an era of interest rate deregulation and the consequent reduction in the "spread" enjoyed by banks and as asset/liability management becomes more difficult, it is important that insured depositories be accorded new means of generating fee income by being able to offer more comprehensive financial services to their customers. As you know, IBAA supported the Administration's proposal in the last Congress to allow bank holding companies to engage in real estate, securities, and insurance activities through separate subsidiaries. Consistent with safety and soundness considerations and the protection of the FDIC fund, we will

continue to support the enactment of such new powers within the context of legislation which firmly closes the nonbank bank loophole. The limited securities powers contained in your bill of last year, Mr. Chairman, will not be utilized by the vast majority of community banks in this nation. We do appreciate, however, the breath of fresh air they will bring to municipal financing and to mortgage financing. Community bankers are particularly interested in brokerage powers for the sale of real estate, insurance, and securities.

The "South Dakota Loophole"

The dual banking system is one of the outstanding features of a Federal system, in which power is decentralized and the individual states can act as laboratories for change. IBAA believes that a proper balance must be maintained between the Federal and state governments in this regard.

We believe this balance should be maintained within the banking system by subjecting the activities of nonbank subsidiaries of bank holding companies to Federal law, while permitting state banks to exercise their charter powers freely except where the states have authorized activities which Congress believes subject the FDIC fund to undue risk. A state chartered bank does not become a creature of Federal law simply because it reorganizes within a bank holding company

so as to enjoy affiliation with an organization that may engage in a broader array of nonbanking activities and receive additional tax considerations.

Applying this formula to the specific instance of insurance powers, IBAA believes that it is wrong when South Dakota or any other state seeks to undermine Federal law applicable to the other forty-nine states in the name of job creation. We think it is equally wrong when the Federal government seeks to tell South Dakota that it may not authorize state chartered banks to exercise such powers solely within South Dakota.

Thus, while we share Senator Dodd's criticism of South Dakota's policy, we cannot endorse his proposed remedy because it tramples too much on the dual banking system. Instead, we believe the problem can be remedied by less draconian means; simply by restricting the exercise of state charter powers which go beyond Federal law solely to the intrastate context; and perhaps by denying utilization of such powers when a bank is acquired by an out-of-state holding company.

If there are some types of insurance activities, or other businesses, which Congress believes are so inherently risky that they should be off-limits for Federally-insured institutions, they should be foreclosed when you enact deposit

insurance reforms. But the critical focus for the Federal government vis-a-vis state banks should be evaluation of risk, not whether a bank is affiliated with a holding company.

Electronic Funds Transfer

Since we last addressed the Committee, the Second Circuit Court of Appeals has reversed the District Court in the case of IBANYS v. Marine Midland. Our New York affiliate has applied to the Supreme Court for certiorari. In addition, the Appeals Court left open the question of whether state law may restrict the operation of automated teller machines (ATMs) by third parties such as supermarkets; and new litigation on interstate electronic funds transfer (EFT) systems has been instituted by the Attorney General of Texas.

We believe that the time has come for Congress to provide legal certainty in this area by legitimizing interstate EFT systems under conditions while preserving delegated state control over deposit-taking. The states must be given the power to bar interstate deposit-taking by national banks utilizing machines owned by third parties.

IBAA believes that S. 1148, Senator Proxmire's "Electronic Banking Competitive Equality Act," would provide fairness and certainty in this area of the law. His bill would permit

national banks to freely connect to ATMs and similar devices throughout the United States to the same extent as state banks, except that national banks could not take interstate deposits unless a state had affirmatively permitted this. Enactment of S. 1148 would lift a legal cloud from EFT systems and permit their continued development in a manner which benefited consumers and treated all banks equitably. It would also restore the local control which the Supreme Court has specified as a vital and basic foundation of our banking system. Under the Proxmire bill, the state would continue to control deposit taking activities within their state by ATM's while preserving the development of interstate ATM networks.

Mr. Chairman, that concludes my prepared remarks. The IBAA looks forward to participating fully in your consideration of comprehensive banking legislation, which we hope will proceed in the near future. I would be pleased to answer any questions.

The CHAIRMAN. Thank you.
Mr. Cairns.

STATEMENT OF JAMES G. CAIRNS, JR., PRESIDENT, PEOPLES NATIONAL BANK OF WASHINGTON, SEATTLE, WA, PRESIDENT, AMERICAN BANKERS ASSOCIATION

Mr. CAIRNS. Thank you, Mr. Chairman. My name is Jim Cairns and I'm president of Peoples National Bank of Washington and also president of the American Bankers Association. The combined assets of our members comprise approximately 95 percent of the industry total. Our membership is obviously quite diverse. As a matter of fact, I think all the banks that are represented on the panel are members of the ABA.

THREE FUNDAMENTAL ISSUES

With that background and understanding of our diversity, it seems to me notable that at ABA's last banking leadership conference 97 percent of the 400 bankers that were present agreed that there are three fundamental issues that must be considered because they are all tied together by marketplace realities. Those issues have been referred to many times this morning—the closing of the nonbank bank loophole, expansion of banking's authority to offer new products and services, and geographic expansion.

The marketplace realities which link these issues have often been noted by you, Mr. Chairman, and other members of the committee. They include proliferation of applications for nonbank bank charters, changing of customers' needs for new financial services, many of which have been developed by our nonbank competitors and cannot today be offered by banks, and finally the emerging regional laws on interstate banking as well as the recently decided Supreme Court decision.

The ABA first adopted its views on these matters in February and then reaffirmed this position in April. There is a strong consensus among bankers for the three-part program, but there's only majority support for the trigger of interstate banking.

In late April, our banking leadership conference, which included about 400 bankers from all across the country, voted by a majority of 55 percent to support the adoption of triggered interstate banking in 5 years, but for only those States which had chosen to participate in regional banking arrangements.

I think this vote points to the difficulty banking has had on one very important element—the changes that are required for our banking system to remain strong and remain able to meet the needs of our Nation's consumers and businesses.

Mr. Chairman, it's difficult not to observe that you've had an opportunity that no one else in the room has had that really would give you an advantage over all the rest of us in understanding what is involved here. By traveling to such heights, you have had the opportunity to look down and see how large this country really is. We have only had the opportunity to get on small airplanes that fly from one segment of the country to another at a very slow pace and not ever see the totality of the whole thing, except for trying to visualize it in a way that only you can do.

This country is large. It is diverse. The needs of the individual consumers and businesses in banks across the country differ because of the size and the nature of the communities in which we are all trying to serve and operate.

It's for this reason that the bankers took the position that the three issues—the nonbank bank loophole closing, the expanded powers and interstate banking—need to be dealt with in a single package because the needs are different, not just in one segment of the country to another but even within a community; and therefore, because we all have different needs, they all need to be dealt with at one time so that everybody can participate and continue to grow and build their own strength and be able to continue to serve the communities and markets in which they are located and operate.

My formal statement, which has been submitted for the record, explores these matters in detail. I would like to take just a few minutes to go into some specific details.

Looking first at the closing of the nonbank bank loophole, we believe that nonbank banks evade the intent of the law because they allow nonbanking and commerce to enter the business of banking. Nonbank banks are, in our judgment, inefficient. Costly facilities are developed and they serve only a limited purpose. Eventually, that inefficiency has to be paid for by the consumers. It's an extravagance that many, if not most, are not for.

Competitive inequality is created by nonbank banks. Where competition is less than fair and free, again, consumers wind up picking up the tab.

For these reasons, we are of the opinion that for the purposes of the Bank Holding Company Act bank should be strictly defined as an FDIC-insured institution or an institution eligible to be insured by the FDIC or any institution that accepts deposits or payments of third parties and is engaged in the business of making commercial loans.

We prefer closing the loophole completely with no grandfathering of any kind. If that is not politically possible, then the grandfather date, in our judgment, should be not later than July 1, 1983.

The Federal Reserve has recommended that the nonthrift thrift loophole also be closed and we concur with that recommendation.

Looking at the need to expand banking's products and services, it's our opinion that bank holding companies should be permitted to enter the following lines of business—offering of mutual funds, underwriting and dealing in municipal revenue bonds and mortgage-backed securities and commercial paper, insurance underwriting and brokerage, and real estate brokerage, development, joint ventures and equity investments.

S. 2851 authorized bank holding companies to underwrite municipal revenue bonds, mortgage-backed securities, and commercial paper. It also clarified that bank holding companies may engage in discount brokerage activities.

In the insurance area, we see tremendous savings for consumers. If banks were permitted to act only as brokers in the area of life insurance alone, we think as much as $940 million a year could be saved by consumers all across the land. It's interesting to note that the chief executive officers of some major insurance companies

have already publicly indicated that they feel that bankers will be able to act as brokers and properly so in the future.

Looking only at residential brokerage in the area of real estate, our estimates are that if banks were permitted to enter that field, as much as $3.6 billion a year could be saved by consumers across the country.

SAVINGS OF $5 BILLION FOR CONSUMERS

Take those two services—life insurance and real estate brokerage—and add those savings together with the $130 million that is already being saved by individuals because we're able to offer discount brokerage, the total comes to $5 billion a year in savings for consumers and that doesn't even include the savings that could be achieved if banks were able to engage in other powers, specifically and certainly including the brokerage of homeowners policies and automobile policies.

We are of the opinion that these new lines of businesses for banks would strengthen the banking system by allowing our industry to build new sources of income. This income is needed to build our capital, to shore up the reserves that have been under considerable pressure, and to pay a fair return to shareholders, something that is essential if we are going to able to attract new capital in sufficient amounts to keep up with the growth of our Nation's economy.

Whenever there are new opportunities for income, there is also the question of risk. In this case, we believe the risk is fully manageable. The expertise is already trained and available in banking and is easily transferred to these new lines of business. The increase in overhead which would occur if we were able to enter many of these new fields translates into major strides in productivity and that, of course, translates into a better bargain for consumers.

It is our considered opinion that the greatest risk is that of doing nothing. If we're foreclosed from the ability to grow capital faster than we can today, the industry cannot remain as safe and sound as it must in the long run.

In summary, diversification into these new services areas will strengthen our banking system.

Finally, let me turn to the subject of geographic expansion. The ABA started the debate on interstate banking in July 1984. Our discussions were made up of large representative groups on no fewer than 10 different occasions. There have been at least six separate votes, always with significant margins, to support the overall three-part legislative program that we have been discussing today.

With respect to interstate banking, there has always been two fundamental questions—what are the potential risks and benefits of interstate banking, and what form should interstate banking take, and how should it be implemented?

On the subject of risks and benefits, opponents of interstate banking say it would distort the flow of funds, weaken the financial system, cause undue concentration, and allow large banks to compete unfairly against small banks.

The facts that we have been able to gather refute all of these claims.

When intrastate geographic restrictions have been removed, no community has been deprived of needed capital.

Where branching restrictions have been removed, for example, in upstate New York, the system has been strengthened, not weakened.

Where branch banking has been allowed intrastate, it's been demonstrated that preexisting concentration in local market areas has been diluted. Studies have also shown that out-of-State acquisitions have not altered market share of local institutions.

With respect to concerns over concentration, history has demonstrated that antitrust laws are more than sufficient to guard against undue concentration.

Regarding the concern for unfair competition, it's been demonstrated over and over again that large banks have no economies of scale that give them unfair advantages over smaller banks. Experience in the States of California and New York indicates that the existence of large institutions in a particular market does not threaten the existence of well-managed smaller institutions.

There are several benefits to be gained, however, in interstate banking—increased competition which always brings lower prices, availability of more and better services and certainly enhanced productivity.

Diversification into new markets areas spreads risk, something we are particularly concerned about today with the problems that are faced by banks operating in small agricultural areas of our country.

In summary, we believe that Federal legislation could and should establish clear and coherent public policy on this matter. The Supreme Court's recent decision on regional banking arrangements leaves to the Congress the issue of whether regional interstate banking laws should at some time lead to full interstate banking. Marketplace pressures suggest the need is great in favor of resolving this question. Allowing interstate banking, while fully protecting each State's right not to participate, would balance the closing of the nonbank bank loophole. ABA believes that the benefits of interstate banking substantially outweigh any risks.

Implementation should be managed properly, however, and with time for all the elements of our industry to understand the change and to adjust their plans. States rights, we believe, should be fully protected. Specifically, we believe the Douglas amendment to the Bank Holding Company Act should be amended to authorize State, regional, and national interstate banking and legislation should establish a specific date on which States who have entered into regional banking arrangements could make a transition to full interstate banking. It is thought that a reasonable time for such a transition is 5 years. Also, each State should have the right to decide not to participate in interstate banking.

During the transition period, each State should have the statutory right to opt out of a regional agreement and thus avoid the trigger.

It's encouraging to note that the House Banking Committee has acted favorably on two of the three priorities identified by bankers,

which I described in my remarks. We applaud the House Committee's initiative. However, we continue to urge action on all three points. It seems to us that there are three basic choices—to do nothing, and that's almost unthinkable; to reregulate, but it's difficult to believe that past benefits achieved by consumers could be taken away; or to continue the process of deregulation, and in the process increase the financial system's safety and soundness, while creating tremendous new benefits for consumers.

Our association believes the choice is clear. We appreciate having the opportunity to express these views.

[The complete prepared statement follows:]

STATEMENT

OF

JAMES G. CAIRNS, JR.

on behalf of

THE AMERICAN BANKERS ASSOCIATION

on

CHANGES IN THE FINANCIAL SERVICES INDUSTRY

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

JUNE 19, 1985

Mr. Chairman and members of the Committee: I am James G. Cairns, Jr., President of Peoples National Bank of Washington in Seattle, and President of the American Bankers Association. The combined assets of our members comprise approximately 95 percent of the industry total. Our members range from the smallest to the largest banks, and close to 85 percent of them have assets of less than $100 million. I welcome the opportunity to present ABA's views on changes in the financial services industry. We compliment the Chairman for scheduling extensive hearings on this important matter.

Our Association believes that there are three issues that must be considered simultaneously because they are tied together by marketplace realities: closing the nonbank-bank loophole, expansion of banking's authority to offer new products and services that consumers want, and geographic expansion. If action on these three issues is linked, the resulting enhanced competition will strengthen the safety and soundness of the nation's financial system and benefit consumers by saving them billions of dollars each year.

These three issues were addressed in the Financial Services Competitive Equity Act of 1984 (S. 2851), legislation that reflected several years of serious effort by Chairman Garn and other members of this Committee to resolve some of the major issues confronting Congress and the regulatory agencies. While these three issues are the main focus of this statement, I will comment briefly on other major provisions of that legislation, many of which should be considered for inclusion in comprehensive legislation during the 99th Congress.

ABA Consensus Position

In February, 400 bankers from every region of the country and every size and type of bank met in Washington, D.C. to set policy direction for the ABA in the 99th Congress. This group, known as the ABA Banking Leadership Conference, concluded that the challenge of closing the nonbank-bank loophole and the

question of geographic expansion are inextricably linked by continuing change in the marketplace. Examples of such change include the proliferation of applications for limited purpose bank charters both by bank holding companies and other nonbank corporate holding companies, and the existing and emerging regional and nationwide laws on interstate banking. Additionally, the bankers observed that an expansion of the list of permissible activities for banking was needed to preserve the industry's ability to serve the needs of its customers and compete in the current environment, as well as to meet marketplace pressures for the consumer benefits that may be derived from an increase in bank services.

For these reasons, the Leadership Conference recommended a legislative package -- endorsed by the ABA Board of Directors -- that links three elements.

Those elements are: (1) the elimination of the nonbank-bank loophole; (2) the expansion of the list of permissible bank holding company activities in the areas of securities, insurance and real estate; and (3) Congressional authorization for geographic expansion within the spirit of states' rights; this would include support for legislation to legitimate regional interstate banking laws while clarifying the authority for states to determine whether to approve or to withdraw from any form of interstate banking within an overall framework providing for full nationwide interstate banking in five years for those states that choose to participate in it.

The Leadership Conference reaffirmed its overall support for this position during our spring meeting in April.

Why Close the Nonbank-Bank Loophole?

The Bank Holding Company Act (BHCA) currently contains a specific definition of the term "bank" for the purposes of the Act. Our Association believes this definition is inadequate for today's marketplace.

Under existing law, a bank is not a bank under the BHCA unless it both takes demand deposits and makes commercial loans. The parent of a limited services bank that refrains from making commercial loans is not subject to the activity limitations of the BHCA, and is free to acquire or charter other limited services banks throughout the country. Alternatively, another limited services bank can make all types of commercial and other loans, accept time deposits, savings accounts and NOW accounts, but escape the BHCA's definition of bank if it does not offer demand deposits. And both types of limited purpose bank can be owned by the same parent, thus offering complementary and complete banking services. Because of this definition, many companies engaged in a wide variety of activities have been able to acquire or apply for charters for limited services state or national banks. These companies include Gulf & Western, J.C. Penney, Merrill Lynch and Dimension Financial Corporation (see the attached table).

The BHCA embodies two major concerns that have run through the history of bank regulation in this country. First, to limit the risks of concentration of economic power, finance (finance, not banking) has historically been separated from commerce both by law and by custom. And second, states have retained the right to determine the structure of banking within their jurisdiction. These concerns have been embodied in Section 4(c) of the BHCA and in the Douglas Amendment to that Act, respectively. However, nonbank banks are able to ignore the statutory mechanisms Congress has established to deal with these concerns.

Community banks are concerned about the ways in which nonbank banks can be used to expand beyond state-enacted geographic limits on bank structure. Larger banks support closing the nonbank-bank loophole to preclude nonbank financial services competitors from offering banking services subject to different regulatory controls than bank holding companies. For many bank holding companies, the only means to compete with other companies providing financial

services on an interstate basis has been to apply for nonbank banks in several states.

Also, a nonbank bank is not the best or most effective means of doing business. They are inefficient. Costly facilities are established in order to serve limited purposes. Eventually, the consumer pays.

Capital is misallocated when it is used to create nonbank banks instead of supporting the wider-scale, more efficient, economic growth that is possible under a traditional bank or bank holding company structure. Again, the cost inevitably is borne by consumers.

Competitive inequity is created when nonbank banks enter markets where local institutions limited by geographic restrictions cannot respond in kind. Whenever competition is less than fair and free, consumers ultimately pick up the tab.

Our Association would strongly oppose any legislation that contains an exclusion for a "consumer bank," a "special purpose bank," or a "family bank" as recently proposed by Sears, Roebuck and Co. This type of institution has been defined as any bank that does not make more than a limited amount of commercial loans. Thus, an insured bank would be able to make certain kinds of loans without becoming a "bank" for BHCA purposes. As an example, those loans could be made for personal, family or household purposes, for charitable purposes, or be secured by residential property. Under the Sears' proposal, a "family bank" would have additional requirements, including no-fee, no minimum-balance checking accounts, and a specified percentage of assets in consumer loans.

A definition of a bank with an exclusion for this type of institution would leave the back door open for organizations in other businesses to invade banking and the payments system. Call this type of institution anything you like and add any requirements you want, it would still circumvent the intent of the BHCA. A "family bank" is simply a nonbank bank with makeup.

Under S. 2851, the nonbank-bank loophole would have been closed by redefining the term bank for the purposes of the BHCA to include any institution insured by the Federal Deposit Insurance Corporation (FDIC) or any institution that both accepts transaction accounts and makes commercial loans. This redefinition would have closed the nonbank-bank loophole by giving the Federal Reserve Board the authority to regulate the companies that own nonbank banks as bank holding companies. Thus, the Douglas Amendment, which prohibits the acquisition of banks across state lines by bank holding companies without state enabling legislation authorizing such acquisitions, would have applied to the parents of nonbank banks.

In addition to certain exemptions for particular classes of nonbanking institutions, S. 2851 would have grandfathered all nonbank banks acquired prior to July 1, 1983 unless the parent company began to engage in additional activities of a financial nature that it was not engaged in before June 28, 1984. Thus, a company which had purchased or chartered a nonbank bank by June 30, 1983 or earlier would have been able to continue to own or control that institution so long as the company did not begin to offer some other financial service, such as securities, insurance, or real estate investment, that it was not in the business of providing before the date of this Committee's mark-up of the legislation, June 27, 1984.

For purposes of the BHCA, our Association believes "bank" should be strictly defined as an FDIC-insured institution, and any institution that accepts demand deposits or withdrawals by similar means for payment to third parties and is engaged in the business of making commercial loans. We also think that the definition could be made more complete by including any institution eligible to be FDIC-insured.

We would prefer that the loophole be closed completely by requiring the divestiture of all nonbank bank subsidiaries. But if that is not possible, the loophole should be closed not later than July 1, 1983. We also support a recommendation of the Federal Reserve Board to close the nonthrift-thrift loophole. Furthermore, the ABA believes that the functional activities of grandfathered institutions that would otherwise be subject to the BHCA and the projected location of nonbank entities be frozen into place as of July 1, 1983.

Closing the nonbank-bank loophole is not the full answer to the problem, however. The marketplace challenges and inequities that stimulated the creation of nonbank banks would still exist if Congress chose only to close the loophole. Therefore, our Association believes that legislation to close the nonbank-bank loophole must be accompanied by provisions that both expand the permissible activities of bank holding companies and address the question of their geographic expansion within the spirit of states' rights.

Expansion of Banking's Products and Services

Even if the nonbank-bank loophole is closed, conglomerates would still be able to offer deposit services to their customers by providing a deposit substitute such as a money market fund or a cash management type account from which third-party transfers can be made, and by selling the deposits of banks or thrifts to their customers as a deposit broker. In addition, they would still be able to offer the same consumer, real estate, and commercial loans as banks while they are providing their primary activities, which in some cases include all of the securities, insurance, and real estate powers outlined in our consensus position. The fact that consumer-type money market funds still have assets of approximately $170 billion despite the tremendous success of the money market deposit account highlights the importance of being able to meet current and future customer needs by offering a full range of financial services.

Our Association believes that the appropriate response to this continuing competitive imbalance would be for Congress to give all financial institutions the authority to offer the full range of financial services that their customers demand. The way to properly diversify the asset portfolio of the banking industry is to allow bank holding companies to enter the fields of securities, insurance and real estate.

Partial deregulation of the banking industry has taken place over the past five years with the phase-out of deposit interest rate ceilings. By one estimate, consumers have received more than $34 billion in interest income that they would not have received from banks had the government maintained the ceilings. But deregulation of bank liabilities without a corresponding ability to offer new products and services limits the industry's ability to serve the economic needs of the nation. The options for addressing this situation are either to re-regulate banking or to continue the process of deregulation to its logical conclusion. We believe that re-regulation is not a viable option -- consumers will not give up the right to market rates of interest they have finally gained. The answer must be further deregulation, both to ensure the future health of the nation's financial institutions and to satisfy increasingly vocal consumer demands for broader choices in financial service-markets.

As consumers, we have at least two basic interests in our financial system. First, we have a fundamental interest in assuring that our nation's financial system is safe and sound. Second, our interest lies in securing the best and most efficient financial services system possible; a system that satisfies our needs for convenience, the best return on our deposits, and the lowest cost for services provided.

It is clear that assuring that our financial system is safe and sound is in the public's best interest. What is required to keep the financial system sound,

now and into the next century? The answer is competition that is fair and free. More regulation and artificial constraints on product markets are not the answer. At the same time, recent events have demonstrated a truth which our industry has long felt to be truism. Deregulation does not and should not mean desupervision. One major concern that our Association has expressed with regard to nonbank banks is the ability of their parent corporations that are not otherwise bank holding companies to escape supervision. In our Banking Leadership Conference consideration of issues relating to the deregulation of the banking industry, I have heard no support for the elimination of or a decrease in the effectiveness of banking examination, supervision, and enforcement.

In this regard, we commissioned an extensive study of methods of ensuring the safety and soundness of our industry in a deregulated environment. The forthcoming results and recommendations of this study should assist this Committee in its consideration of the types of supervisory agency changes that may be necessary to accompany further deregulation. But further deregulation must be accompanied by reconsideration of the types of financial service organizations that will be regulated as banks and allowed to provide banking services.

All of us as consumers have been sensitized by inflation, which has forced us to seek the maximum possible return on our deposits, and by the need to obtain in a convenient way a very wide variety of financial products and services. The problem is that outmoded laws and regulations essentially limit banks to three lines of business -- taking deposits, making loans and operating the payments system. While banks remain bound by these limitations, other organizations -- Sears, Prudential, American Express and scores of others -- are pioneering the financial services and service packages that consumers require. There is competition today, but it is not fair or free.

Profits lie at the heart of our industry's soundness. Profits are used to build capital, to shore up reserves when necessary and of course to pay a fair return to shareholders, thus ensuring a continued supply of new capital when it is needed to support economic growth. The key to profitability is competition that is fair and free. The way to achieve fair competition is deregulation. Not a reduction of bank supervision and examination, but a removal of the artificial barriers to competition that today block banks from competing fully, efficiently and effectively. We believe bank holding companies should be allowed to enter new lines of business -- in the field of securities: the offering of mutual funds, and underwriting and dealing in municipal revenue bonds, mortgage-backed securities, and commercial paper; in the field of insurance: underwriting and brokerage; in the field of real estate: equity investments, joint ventures, development and brokerage.

Early this year, I asked the Research Division of the ABA to work with an independent consultant to develop reliable estimates of the benefits that consumers would receive from deregulation. To establish a baseline, they first investigated the benefits from a service that more than 2,000 banks began to offer recently, discount brokerage. The researchers found that, on average, the customer who uses a bank-affiliated discount brokerage service saves about $250 a year in commissions over the customer who goes to a full-service broker. Nationwide, that could work out to be about $130 million in savings for consumers each year.

Next, the researchers looked at life insurance. On a per customer basis, they estimated that bankers could save the average consumer about $72 a year. The market for life insurance is so large, the aggregate savings for all consumers in the United States could be about $940 million each year.

Finally, they found that consumers might benefit if banks engaged in residential real estate brokerage. If banks acted as real estate brokers, they estimated that the commission rate could drop to 4.5% for existing homes and 3.6% for new homes. This estimate is based on the experience in Great Britain where banks provide essentially the same service. Based on the dollar volume of new and existing homes sold in 1984, this could have led to a total savings for the consumers of America of $3.6 billion.

Taking only the three areas -- discount brokerage, life insurance and residential real estate brokerage — this research indicates that, given the authority, bank holding companies may be able to save consumers nearly $5 billion a year. Left unaddressed by these estimates are the additional savings that would be generated for consumers if bank holding companies were able to offer securities services such as underwriting revenue bonds or managing mutual funds. Additional savings would be generated if bank holding companies were able to act as brokers for other insurance products such as homeowners and automobile policies, or if bank holding companies were permitted to offer real estate services such as commercial brokerage and property management. The savings for consumers if bank holding companies were allowed to offer services in all these areas could be considerable.

As bank holding companies move to provide a broader product line to consumers, an eye must be kept on risk. Risk exists in any business activity. However, thorough analysis, combined with experience gained by some banks authorized by state laws to enter certain new fields, suggests that those risks are fully manageable. Further, these new lines of business are so similar to traditional banking activities that bankers' existing expertise can be transferred and applied effectively to the new activities. More important, banks' existing investment in buildings, computers, equipment and people can be

used to support new consumer services with little or no increase in overhead costs.

There is, however, a much greater risk — the risk of doing nothing, of chaining the banking industry to the bench of tradition, and in the process not generating earnings to add to capital. Over the long term, if capital does not grow, the industry cannot remain safe and sound. Diversification into new consumer services is the way to produce earnings and build capital. Diversification also is one of the keys to strength in our modern economy. Put in the simplest terms, it is necessary to diversify the business of banking precisely because that is one of the best ways of reducing risk. By offering new financial products, banks could save consumers billions of dollars. In the process, banks also would generate earnings from fee income — earnings that are required to keep the American financial system safe and sound.

S. 2851 contained several modest expansions of the securities authority of bank holding companies. It authorized bank holding companies to underwrite municipal revenue bonds, mortgage-backed securities, and commercial paper. In addition, it clarified that bank holding companies may engage in discount brokerage activities. Bank holding companies have been engaged in discount brokerage for a number of years. The offering of municipal revenue bond and mortgage-backed security underwriting services by bank holding companies would bring needed competition to these two very limited markets. Additional competition in the municipal revenue bond market should reduce the costs to municipalities of having their securities underwritten. For this reason, all the major organizations of state and local governments, such as the National Governors Association, National Association of Counties, National League of Cities, U.S. Conference of Mayors, and Municipal Finance Officers Association, have endorsed bank holding company underwriting of revenue bonds. Additional

competition in the mortgage-backed security market should reduce the costs to the housing market of raising additional capital for home building purposes. Our Association strongly supported these provisions of S. 2851.

Moreover, we strongly supported Chairman Garn's effort to amend S. 2851 to authorize mutual fund sponsorship and underwriting for depository institution securities affiliates. As you stated Mr. Chairman, deleting that provision from the bill was inconsistent with a competitive and strong financial system.

A recent study prepared by an independent consultant for ABA's Trust Division found that the investment performance of equities managed by banks from 1975-1984 compared favorably to that of other manager groups, including mutual funds and insurance companies. In fact, for the most recent three years, the weighted average bank return surpassed all other groups. Another recent study by Market Facts, Inc. found that 20 percent of U.S. households want to buy mutual funds from banks. These results help to explain why several mutual fund management firms, including Dreyfus and Fidelity Investments, are aggressively trying to enlist banks in their programs to market their funds through banks.

It should be noted that similar arrangements are also increasing between insurance companies and commercial banks. As an example, the Equitable Life Assurance Society of the United States is planning to sell consumer life, health, and other insurance policies at four Bank of America branches in the San Francisco area. Bank of America already has a joint program with Capital Holding Corporation's life insurance subsidiary.

In order to ensure that these new securities powers of bank holding companies were not engaged in an unsafe or unsound fashion, or in any anti-competitive fashion, S. 2851 contained a number of restrictions. First, these new securities powers had to be engaged in through a bank holding company or one of its nonbanking subsidiaries or affiliates rather than through a commercial

bank itself; second, any existing securities activities within a commercial bank had to be transferred within one year to the holding company or its nonbanking securities affiliate; the Securities and Exchange Commission would be the appropriate regulatory authority for bank holding company securities affiliates; and very strict restrictions would be placed on any dealings between a bank subsidiary of a holding company and any security subsidiary or affiliate of the holding company.

To preserve banking's ability to serve the needs of its customers and compete in the current environment, our Association believes that legislation to expand the permissible activities of bank holding companies must include the sponsorship and sale of mutual funds; the underwriting of municipal revenue bonds, mortgage-backed securities and commercial paper; insurance underwriting and brokerage; and real estate equity investments, joint ventures, development and brokerage. Also, it must close the nonbank-bank loophole and authorize geographic expansion within the spirit of states' rights.

Interstate Banking

The ABA first initiated debate of interstate banking in July of 1984. Since then, this subject has been discussed with large, representative groups no fewer then ten times — groups representing all the diversity of the industry, large and small banks, all types of banks from all over the country.

We have taken at least six votes on interstate banking. While every detail of ABA's position is not supported by every banker in the country, certain broad principles have received overwhelming backing. It is clear that our Banking Leadership Conference strongly supports legislation to reaffirm the ability of states to determine whether to authorize regional or national interstate banking. It is also clear that a strong consensus exists for authorizing any state to withdraw from a regional interstate banking agreement prior to the date of any

nationwide trigger. The rub is the nationwide trigger. Our Association's Banking Leadership Conference supports, by a 55-45 percentage point margin, a provision in federal legislation providing that any state authorizing regional interstate banking would become part of a nationwide system in five years.

Further deregulation of banking will significantly enhance safety and soundness -- the paramount public policy concern. Deregulation as advocated by ABA would diversify banking -- not only in terms of products and services offered, but also in terms of geographic location.

Diversification would spread risk, generate new sources of earnings and over the long term strengthen the capital base. All three are necessary.

Spreading risk means operating in more than one or a few lines of business. When this happens, earnings in one area can cushion the impact of downturns in other areas. Spreading risk further by operating in more than one limited geographic area strengthens the equation even more -- when one local economy suffers a setback, earnings derived from operations in other communities allow the business process to continue unimpeded.

New sources of earnings also help to balance the net interest margin squeeze that has been created by deposit interest rate deregulation, again strengthening safety and soundness.

The ultimate importance of earnings -- over and above paying shareholders a return sufficient to assure future access to new capital -- is that earnings can be applied to capital and set aside in reserve accounts, which are the first line of defense of the industry's safety and soundness.

Financial deregulation to date has followed a somewhat crazy-quilt pattern. Deposit interest rate deregulation brought consumers as much as $34 billion in interest income which they would not have received if rate ceilings had been

maintained, but it was not accompanied by deregulation on the asset side to allow banks to offer new products and service.

On the state level, however, innovation has taken place, particularly on the question of interstate banking. While federal law has remained unchanged, the state legislatures have led the way by engineering the various regional banking arrangements that are spreading rapidly across the country (see the attached summary of recent state legislative developments).

The problem is that there is no coherent pattern to this process. Uneven treatment and marketplace uncertainty has been the result. Thus, the opportunity exists for federal legislation to establish clear public policy regarding interstate banking and in the process resolve uncertainties that currently characterize the marketplace.

The benefit, simply put, would be assurance that the process of change is being directed by a public policy designed to assure fair and free competition — and to protect each state's right to make its own decisions on interstate banking.

Under the legislative package proposed by ABA, capital would be allocated and used much more efficiently than is the case today.

Nonbank banks, for example, require the same capitalization as full-service banks, but provide consumers fewer services. Traditional bank holding company structures make a far more efficient use of capital.

Nonbank banks are being used for two purposes. They allow nonbanking conglomerates to enter the business of banking while evading the Bank Holding Company Act. They also allow banking organizations to cross state lines, although with limited service offerings.

It is clear that nonbank banks have serious drawbacks.

Thus, ABA is proposing to close the nonbank-bank loophole and balance that action by establishing a clear and coherent national policy on interstate banking.

In the process, more efficient use of capital would be assured. When capital is misused, or used with less than the maximum possible efficiency, the financial system will be weakened. When efficient use of capital is allowed, the system will be strengthened.

Implementation

ABA believes, first of all, that a change as important as a move to interstate banking should be managed cautiously, with adequate time allowed for all elements of the industry to understand the change and adjust their plans accordingly.

We should not lose sight of the fact that in many respects interstate banking already exists. As early as 1983, there were 7,840 interstate offices of banks and bank holding companies, loan production offices, Edge Act corporations and grandfathered interstate bank holding companies. If the interstate offices of Merrill Lynch, Sears and American Express were added to the tally, that number would increase to at least 15,000 interstate banking offices.

In addition, regional banking arrangements now in existence or under active consideration by state legislatures nearly blanket the nation. This interstate banking activity does not extend through the full spectrum of the banking community, however, and thus a phase-in period is needed.

As passed by the Senate, S. 2851 would have clarified the authority of states to authorize out-of-state bank holding companies to acquire banks within their jurisdictions by sanctioning regional agreements for five years. The Douglas Amendment to the Bank Holding Company Act today authorizes states to pass laws allowing out-of-state bank holding companies to acquire banks within their

territory; however, questions have been raised as to whether the Douglas Amendment permits states to limit to a specific region or to a specific group of other states the states from which an out-of-state holding company may acquire banks. The June 10 Supreme Court decision affirmed the rights of states to determine the structure within their boundaries, and clarifies states' authority to pass regional interstate laws. The Court's decision leaves to Congress the issue of whether regional interstate banking laws should at some time in the future lead to nationwide banking.

The ABA consensus position on the issue of geographic expansion of bank holding companies is predicated on three principles. First, we believe that each state should be able to exercise its sovereign rights to determine whether to allow out-of-state bank holding companies to operate within its borders. Second, we support the concept of regional banking laws entered into between and among the various states. Third, we believe that states that have entered into regional banking arrangements should have the right to opt out of those regional laws before any federal law mandating nationwide interstate banking goes into effect. By a 55 to 45 percentage point margin, our Association's Banking Leadership Conference also supports a provision requiring a transition to full interstate banking, for those states passing regional banking laws, in five years. During the transition period, each state should have the statutory right to opt out of any interstate banking requirement in federal law. Additionally, we believe that legislation which would allow interstate banking must be tied to elimination of the nonbank-bank loophole and to authorization for bank holding companies to offer new products and services in the areas of securities, insurance and real estate.

Other Major Provisions of S. 2851

The Financial Services Competitive Act of 1984 (S. 2851) contained several other major provisions. The following section includes a brief description of each provision, a very short analysis of its impact on the commercial banking industry, and the position of the ABA on it. Our Association believes that many of these or similar provisions should be considered for inclusion in comprehensive legislation during the 99th Congress.

Restrictions on State-Chartered Banks

S. 2851 would have imposed two restrictions on state-chartered bank subsidiaries of bank holding companies. The first restriction would have closed the so-called South Dakota loophole by prohibiting a state-chartered bank subsidiary of a bank holding company from engaging in any activities outside of the state in which it is located that are prohibited to bank holding companies. Thus, if a state such as California authorizes its state-chartered banks to offer real estate equity financing, this provision would preclude those state-chartered banks that are subsidiaries of bank holding companies from taking full advantage of that state authorization. The ABA opposed this provision.

S. 2851 also would have precluded state-chartered bank subsidiaries of bank holding companies from offering any insurance products that are prohibited to bank holding companies under Title VI of the Garn-St Germain Depository Institutions Act of 1982. This provision would have taken away from states the authority to authorize their state-chartered bank institutions to offer a full range of insurance products so long as those state-chartered banks were subsidiaries of bank holding companies. There was no effective grandfather clause in this provision for state-chartered banks, and a grandfather date of May 1, 1982 for bank holding companies. Thus, any bank holding company that entered the insurance business through a state-chartered bank, pursuant to state

authorization, after May 1, 1982 would have been forced to divest either the insurance business or the bank. Moreover, any state-chartered bank that was engaged in the insurance business and was not a subsidiary of a bank holding company or became one after May 1, 1982, would have been precluded by this provision from forming a bank holding company or being acquired by a bank holding company unless it divested itself of its insurance activities. Our Association strongly opposed this provision as extraordinary federal interference with states' rights to supervise and regulate the banks that they charter. We strongly supported Chairman Garn's amendment to strike this onerous provision from the bill.

Glass-Steagall Application

S. 2851 would have extended the prohibitions of the Glass-Steagall Act to state-chartered banks that are not members of the Federal Reserve System and to thrift institutions. However, thrift institutions would have been authorized to engage in a wide range of securities activities, such as offering mutual funds, that would be prohibited to state-chartered banks. The ABA opposed this provision.

Bank Holding Company Formation

S. 2851 would have substantially simplified the formation of a bank holding company by an existing bank by exempting a simple bank holding company formation form certain securities laws and by simplifying the application process at the Federal Reserve Board for such holding company formation. This provision would have saved many thousands of dollars and considerable time and effort for each bank contemplating the formation of a bank holding company. Our Association supported this provision.

Section 4(c)(8) Revision

S. 2851 would have authorized bank holding companies to engage in any activity that is closely related to banking. This would have been a slight modification of the existing test which requires that the Federal Reserve Board find that an activity is so closely related to banking as to be a proper incident thereto before authorizing bank holding companies to engage in it. It should be noted that the Board has very rarely used the so-called proper incident test in authorizing bank holding company activities other than to prohibit holding companies from acquiring healthy thrift institutions, a provision that is addressed below. The ABA supported this provision.

Savings and Loan/Bank Acquisition

S. 2851 would have authorized bank holding companies to acquire healthy savings and loan associations (they are authorized to acquire failing thrift institutions). Any savings and loan acquired by a bank holding company would have been subject to the restrictions of the Douglas Amendment and the McFadden Act as they apply to branching by any commercial bank subsidiary of that bank holding company. The provision would have allowed bank holding companies to be more competitive with thrift institutions, which have generally had a broader range of powers in recent years than commercial banks. Our Association supported this provision.

Thrift Institutions

S. 2851 would have established for the first time in law the concept of a qualified thrift lender which, in return for maintaining a substantial percentage of its assets in mortgages and related activities would have been provided certain statutory advantages over other types of depository institutions. Under S. 2851, a qualified thrift lender would have been required to maintain 60

percent of its assets in mortgages, mortgaged-backed securities, and certain liquidity investments. In return for this limitation, the parent companies owning qualified thrift lenders would have been subject to no activities limitations similar to those that apply to bank holding companies. Companies owning non-qualified thrift lenders or multiple savings and loan holding companies would have been subject to restrictions on the types of activities in which they could engage similar to those applicable to bank holding companies. In addition, all thrift holding companies would have been authorized to purchase commercial banks, subject to the restrictions of the McFadden Act (on branching) and the Douglas Amendment (on out-of-state acquisition). The ABA would prefer to see identical treatment applied to qualified thrift lenders and their parents as applied to bank holding companies.

Demand Deposits

S. 2851 would have authorized federal savings and loan associations to offer checking accounts to all of their customers. Federal savings and loans today are limited to offering checking accounts primarily to their nonbusiness customers. This provision was strongly opposed by our Association.

Capital Assistance Program

S. 2851 would have extended for three years the capital assistance program for troubled institutions which is scheduled to expire in October 1985. In addition, it would have extended the program to a small class of agricultural banks which maintain at least 20 percent of their assets in agricultural loans. The ABA did not oppose this provision.

Leasing Authority

S. 2851 would have authorized national banks to lease tangible personal property in amounts up to 10 percent of the assets of the bank. This provision

was identical to authority granted federal savings and loan associations by the Garn-St Germain Depository Institutions Act of 1982. This provision was supported by the ABA.

Mutual Holding Companies

S. 2851 contained language authorizing the establishment of holding companies by mutual thrift institutions. These holding companies would have enabled mutual institutions to avail themselves of the new authorization extended to bank holding companies and multiple savings and loan holding companies. Our Association was not opposed to this provision.

Bankers Banks

Title III of S. 2851 would have strengthened the authority of smaller commercial banks to jointly charter bankers banks to perform correspondent banking services for themselves. Our Association was supportive of this title.

Leasing

Title IV of S. 2851 would have provided for additional consumer protection by adding a new title to the Consumer Credit Protection Act that would govern consumer leases and lease purchase agreements. In general, the major provisions of this title would have simplified disclosure requirements for consumers, provided disclosure in a more meaningful form, and extended disclosure requirements to lease purchase agreements. The ABA supported this title.

Deposit Availability

Title V of S. 2851 would have governed the problem of "delayed availability" by requiring depository institutions to notify their customers of their so-called check hold policies and by establishing a task force under the Federal Reserve Board to speed the return of dishonored checks so as to limit the amount of time

during which a consumer's check must be held by a depository institution. Our Association supports voluntary disclosure of funds availability policies by institutions rather than a legislatively mandated approach.

Usury

Title VI of S. 2851 would have established a limited federal usury override that would have reinstated the federal override relating to business and agricultural loans that expired in 1983. This limited override would have allowed a rate of up to 5 percent in excess of the three year Treasury bill rate to be charged on business and agricultural loans. It would have expired on July 1, 1987. One provision of this title, however, would have completely preempted any state usury ceiling on any type of loan for federal credit unions. The ABA supports the total preemption of state usury ceilings for commercial banks as well as credit unions.

Deposit Brokers

Title VII of S. 2851 provided for the federal regulation of brokered deposits. It would have prohibited institutions insured by the FSLIC or the FDIC from accepting short-term (under one year) insured brokered deposits in amounts in excess of 200 percent of an institution's capital and surplus. However, any institution with capital below 3 percent would have been totally prohibited from accepting brokered deposits, and no institution could have accepted brokered deposits in excess of 15 percent of its total deposits. This title did not address all of the concerns raised by the proliferation of brokered deposits in insured banks. We would therefore support legislation that would require the registration with the federal deposit insurance agencies of any deposit brokers not otherwise supervised as securities broker/dealers or as depository institutions. In addition, we believe the authority of the federal banking

agencies to limit the acceptance of insured brokered deposits by problem banks should be clarified in this legislation; no distinction should be made between long- and short-term insured brokered deposits; and no deposit broker should be able to offer a customer "more" deposit insurance (through the splitting of brokered deposits) then can an insured commercial bank.

Miscellaneous

S. 2851 contained a number of miscellaneous amendments. Among the more important of these was a provision that would have authorized campaign or political action committees to open interest-bearing NOW accounts; a provision that would have required the federal bank regulatory agencies to conduct a six month study of how the risk of bank failures may be reduced; a provision that would have prohibited the Student Loan Marketing Association from purchasing a savings and loan association; a provision that would have imposed a five percentage point cap on the interest rate increases within an adjustable rate mortgage loan; and a provision that would have required disclosure by financial institutions of all fees and charges imposed on all types of deposit accounts and any changes in those fees and charges. While most of these provisions were acceptable to the ABA, the latter two were adopted after no hearings, and involved matters of broad scope. Those provisions were opposed by our Association.

Payment of Interest on Reserves

During the floor debate on S. 2851, a provision which required the Federal Reserve to pay interest on reserves for interest-bearing transaction accounts was deleted. As we testified before this Committee last year, the requirement that depository institutions hold their reserves in noninterest bearing form imposes an implicit tax on those institutions. This tax reduces the interest rate

depository institutions can afford to pay on deposits, making it difficult for them to compete with other institutions that offer deposit-like instruments not subject to reserves. By limiting payment of interest to reserves held against interest-bearing transaction accounts, most commercial banks would receive interest on only a small portion of their reserves. Elimination of the implicit tax on deposits requires that interest be paid on all reserves held at the Federal Reserve.

Conclusion

The choices for banking fall under three headings:

1) Do nothing, but that is unthinkable.

2) Reregulate, but it is difficult to believe that past benefits achieved by consumers could be taken away.

3) Continue the process of deregulation, and in the process increase the financial system's safety and soundness, while creating tremendous new benefits for consumers.

Our Association believes the choice is clear.

Thus, Mr. Chairman, the ABA supports legislation to close the nonbank-bank loophole, expand banking's authority to offer new products and services, and allow for geographic expansion. Such legislation would allow fair and free competition, strengthen the financial system's safety and soundness, and benefit consumers. As outlined in the preceding section, we also believe that many other changes should be made to address other concerns raised by those who work within and those who regulate depository institutions.

Thank you. I would be pleased to answer any questions the Committee may have.

U.S. BANKS AND TRUST COMPANIES
CONTROLLED BY NONBANK INTERESTS
INCLUDING PENDING AND PLANNED APPLICATIONS AND ACQUISITIONS
Revised April 9, 1985

Bank	Parent Company	Acquired/ Formed
ARIZONA		
Dimension Bank of Arizona NA, Phoenix	Dimension Financial Corp., Denver, CO	(2)
Great Western Bank, Phoenix	Great Western Financial Corp., Los Angeles	(2)
Lyndon Guaranty Bank, Mesa	ITT Financial Corp., St. Louis, Mo.	(2)
CALIFORNIA		
Associates National Bank, Concord	Gulf & Western Corp., New York	1980
Avco National Bank, Anaheim	Avco Corp., Greenwich, CT	1982
Bank of Santa Ana, Santa Ana	First American Title Co., Santa Ana	(2)
Capital Guardian Trust Co., Los Angeles	The Capital Group Inc., Los Angeles	1968
Dimension Bank of California NA, San Mateo	Dimension Financial Corp., Denver, CO	(1)
Int'l Central Bank & Trust Corp., Irvine	Continental Corp., New York	1983
Pacific Securities Depository Trust Co., San Francisco	Pacific Coast Stock Exchange, San Francisco	1974
Security Trust Co., Los Angeles	Bradford National Corp., New York	1981
Trust Services of America Inc., Los Angeles	Calif. Federal Savings & Loan Assn., Los Angeles	1982
Valley National Bank of Salinas	Household Int'l, Prospect Heights, IL	1981
Western Family Bank NA, Carlsbad	McMahan Valley Stores, Carlsbad	1983
COLORADO		
Dimension Bank of Colorado NA, Englewood	Dimension Financial Corp., Denver CO	(2)
First Union National Bank, Denver	Four international unions, 34 locals	1983
Great Western Bank, Aurora	Great Western Financial Corp., Los Angeles	(2)
Resources Trust Co., Englewood	Integrated Resources Inc., New York	1983
CONNECTICUT		
Advest Bank, Hartford	Advest Group Inc., Hartford	1984
Citizens National Bank, Fairfield	Gateway Bank, South Norwalk	1984
Dimension Bank of Connecticut NA, Stamford	Dimension Financial Corp., Denver CO	(2)
DELAWARE		
+ American Express Centurion Bank, Stanton	American Express Co., New York	(2)
Beneficial National Bank, Wilmington	Beneficial Corp., Wilmington	1952
Beneficial National Bank (USA), Wilmington	Beneficial Corp., Wilmington	1983
Colonial National Bank, Wilmington	Teachers Svcs. Organizations, Willow Grove, Pennsylvania	1982
Delaware Charter Guarantee & Trust Co., Wilmington	Corporation Service Co., Wilmington	1977
Dimension Bank of Delaware NA, Wilmington	Dimension Financial Corp., Denver CO	(2)
First National Bank of Wilmington	Commercial Credit Corp., Baltimore	1984
Greenwood Trust Co., Greenwood	Sears, Roebuck & Co., Chicago	1985
E.F. Hutton Trust Co., Wilmington	E.F. Hutton Group Inc., New York	1982
E.F. Hutton Bank, Wilmington	E.F. Hutton Group Inc., New York	1984

U.S. BANKS AND TRUST COMPANIES CONTROLLED BY NONBANK INTERESTS (Cont.d)

Bank	Parent Company	Acquired/ Formed
DELAWARE (Cont.d)		
JCPenney National Bank, Harrington	J.C. Penney & Co. Inc., New York	1983
PSFS Delware NA, Wilmington	Philadelphia Savings Fund Society	(2)
DISTRICT OF COLUMBIA		
National Bank of Washington	United Mine Workers of America	1885
FLORIDA		
Dimension Bank of Boca Raton NA	Dimension Financial Corp., Denver, CO	(1)
Dimension Bank of Fort Meyers NA	Dimension Financial Corp., Denver, CO	(2)
Dimension Bank of Sarasota NA	Dimension Financial Corp., Denver, CO	(2)
Dimension Bank of Winter Park NA	Dimension Financial Corp., Denver, CO	(2)
Great Western Bank, Boca Raton	Great Western Financial Corp., Los Angeles	(2)
Lyndon Guaranty Bank NA, Tampa	ITT Financial Corp., St. Louis, MO	(2)
Southern Bank of Broward County, Pompano Beach	Continental Telecom Inc., Atlanta	(3)
Templeton Mgmt. & Trust Co. NA, Ft. Lauderdale	Principals of the Templeton Group of mutual funds, Nassau, Bahamas	(1)
Trust Co. of Naples Inc.	NAPCO Financial Group Inc., Naples	1984
GEORGIA		
Great Western Bank, Atlanta	Great Western Financial Corp., Los Angeles	(2)
Prudential Bank & Trust Co., Hapeville	Prudential-Bache Securities Inc., New York	1983
Dimension Bank of Georgia NA, Atlanta	Dimension Financial Corp., Denver, CO	(2)
HAWAII		
Great Western Bank, Honolulu	Great Western Financial Corp., Los Angeles	(2)
ILLINOIS		
Chicago Title & Trust Co., Chicago	Lincoln National Corp., Fort Wayne, IN	1979
Dimension Bank of Chicago NA, Northbrook	Dimension Financial Corp., Denver, CO	(2)
Great Western Bank, Chicago	Great Western Financial Corp., Los Angeles	(2)
Midwest Securities Trust Co., Chicago	Midwest Stock Exchange, Chicago	1973
Washington National Trust Co., Evanston	Washington National Corp.	1975
KANSAS		
Brotherhood Bank & Trust Co., Kansas City	International Brotherhood of Boilermakers	1924
KENTUCKY		
Dimension Bank of Kentucky NA, Louisville	Dimension Financial Corp., Denver, CO	(2)
Hillyard Lyons Trust Co., Louisville	J.J.B. Hilliyard, W.B. Lyons Inc., Louisville	1983

U.S. BANKS AND TRUST COMPANIES CONTROLLED BY NONBANK INTERESTS (Cont.d)

Bank	Parent Company	Acquired/ Formed
LOUISIANA		
Dimension Bank of New Orleans NA	Dimension Financial Corp., Denver, CO	(2)
Great Western Bank, New Orleans	Great Western Financial Corp., Los Angeles	(2)
MARYLAND		
Dimension Bank of Maryland, Bethesda	Dimension Financial Corp., Denver, CO	(2)
T. Rowe Price Trust Co., Baltimore	T. Rowe Price & Associates Inc., Baltimore	1983
MASSACHUSETTS		
Boston Safe Deposit & Trust Co.	Shearson/American Express Inc., New York	1981
Bradford Trust Co. of Boston	Bradford National Corp., New York	1975
Dimension Bank of Massachusetts NA, Newton	Dimension Financial Corp., Denver, CO	(1)
Investors Bank & Trust Co., Boston	Eaton Vance Corp., Boston	1969
Fidelity Management Trust Co., Boston	Fidelity Management & Research Co., Boston	1981
Marsh & McLennan Trust Co., Boston	Marsh & McLennan Inc., New York	1983
Massachusetts Co., Boston	Travelers Corp., Hartford CT	1969
Trust Management Bank, Boston	Rollert & Sullivan Inc., Boston	1984
Wellington Trust Co. of Boston NA	Wellington Mgmt Co./Thorndike, Doran, Paine & Lewis, Boston	1982
MICHIGAN		
Automotive Financial Services., Inc. Highland Park	Chrysler Corp., Detroit	1981
MINNESOTA		
Dimension Bank of Minnesota NA, Edina	Dimension Financial Corp., Denver, CO	(2)
IDS Trust Co., Minneapolis	American Express Co., New York	1979
Eastern Heights State Bank, St. Paul	Minnesota Mining & Manufacturing Co., St. Paul	1958
Union Bank & Trust Co., Minneapolis	Twenty-two labor unions	1976
MISSISSIPPI		
Great Western Bank, Jackson	Great Western Financial Corp., Los Angeles	(2)
MISSOURI		
Dimension Bank of Missouri NA, Kansas City	Dimension Financial Corp., Denver, CO	(2)
Investors Fiduciary Trust Co., Kansas City	DST Inc., Kansas City	1972
NEVADA		
Dimension Bank of Nevada NA, Las Vegas	Dimension Financial Corp., Denver, CO	(2)
NEW HAMPSHIRE		
Fidelity Bank & Trust Co., Salem, NH	Fidelity Mgmt & Research Corp., Boston	1983
First Deposit National Bank, Tilton	Capital Holding Corp., Louisville, KY	1984

U.S. BANKS AND TRUST COMPANIES CONTROLLED BY NONBANK INTERESTS (Cont.d)

Bank	Parent Company	Acquired/ Formed
NEW JERSEY		
American Bank of New Jersey, Gibbsboro	Aetna Life & Casualty Co., Hartford	(2)
City Trust Services NA, Elizabeth	City Federal Savings & Loan Assoc., Elizabeth	1975
Custodial Trust Co., Trenton	Bear Stearns & Co., New York	(2)
Dimension Bank of New Jersey NA, Morristown	Dimension Financial Corp., Denver, CO	(2)
Drexel Trust Co., Paramus	Drexel Burnham Lambert Group Inc., New York	1983
Dreyfus Consumer Bank, East Orange	Dreyfus Corp., New York	1983
Merrill Lynch Bank & Trust Co., Plainsboro Township	Merrill Lynch & Co. Inc., New York	1984
Paine Webber Trust Co., Princeton	Paine Webber Group Inc., New York	(1)
Thomson McKinnon Bank & Trust Co., East Hanover	Thomson McKinnon Securities Inc., New York	(1)
NEW MEXICO		
Great Western Bank, Albuquerque	Great Western Financial Corp., Los Angeles	(2)
NEW YORK		
Amalgamated Bank, New York	Amalgamated Clothing & Textile Workers Union, New York	1923
American Express Bank Int'l, New York	American Express Co., New York	(4)
Bradford Trust Co., New York	Bradford National Corp., New York	1972
Depositors First National Bank, New York	General partners of Reserve Mgmt. Co., New York	(1)
Depository Trust Co. of New York	New York Stock Exchange and other users	1973
Dimension Bank of New York NA, White Plains	Dimension Financial Corp., Denver, CO	(2)
Dreyfus Trust Co., Garden City	Dreyfus Corp., New York	(1)
Fidelity National Bank & Trust Co.	Fidelity Mgmt & Research Corp., Boston	(1)
Great Western Bank, New York	Great Western Financial Corp., Los Angeles	(2)
Lyndon Guaranty Bank, New York	ITT Financial Corp., St. Louis, MO	(2)
Macy's Bank, New York	R.H. Macy & Co. Inc., New York	1941
Merrill Lynch Bank International, New York	Merrill Lynch & Co. Inc., New York	1984
Savings Bank Trust Co., New York	Mutual savings banks of New York State	1933
J. & W. Seligman Trust Co., New York	J. & W. Seligman & Co., New York	1982
NORTH CAROLINA		
Manning & Napier Trust Co. Inc.	Manning & Napier Advisors Inc., Rochester, NY	(4)
OKLAHOMA		
Dimension Bank of Oklahoma NA, Tulsa	Dimension Financial Corp., Denver, CO	(2)
Great Western Bank, Tulsa	Great Western Financial Corp., Los Angeles	(2)
OHIO		
Lyndon Guaranty Bank, Columbus	ITT Financial Corp., St. Louis, MO	(2)
The Ohio Co. trust department, Columbus	The Ohio Co., Columbus	1976

U.S. BANKS AND TRUST COMPANIES CONTROLLED BY NONBANK INTERESTS (Cont.d)

Bank	Parent Company	Acquired/ Formed
OREGON		
Columbia Trust Co., Portland	Columbia Management Co., Portland	1980
Dimension Bank of Oregon NA, Portland	Dimension Financial Corp., Denver, CO	(2)
PENNSYLVANIA		
Dimension Bank of Pennsylvania NA, Bryn Mawr	Dimension Financial Corp., Denver, CO	(2)
Philadelphia Depository Trust Co., Philadelphia	Philadelphia Stock Exchange	1979
Vanguard Fiduciary Trust Co., Valley Forge	Vanguard Group Inc., Valley Forge	1982
PUERTO RICO		
Commonwealth Trust Co., San Juan	A. G. Becker Paribas Inc., New York	(2)
Universal Trust Co., San Juan	First Boston Inc., New York	(3)
RHODE ISLAND		
Dimension Bank of Rhode Island NA, Newport	Dimension Financial Corp., Denver, CO	(2)
Mutual Benefit Trust Co., Providence	Mutual Benefit Life Insurance Co., Newark, NJ	1983
SOUTH CAROLINA		
Great Western Bank, Charleston	Great Western Financial Corp., Los Angeles	(2)
TENNESSEE		
Dimension Bank of Tennessee NA, Nashville	Dimension Financial Corp., Denver, CO	(2)
Great Western Bank, Memphis	Great Western Financial Corp., Los Angeles	(2)
TEXAS		
Dimension Bank of Austin NA	Dimension Financial Corp., Denver, CO	(2)
Dimension Bank of Dallas NA	Dimension Financial Corp., Denver, CO	(2)
Dimension Bank of Houston NA	Dimension Financial Corp., Denver, CO	(2)
Dimension Bank of San Antonio NA	Dimension Financial Corp., Denver, CO	(2)
Great Western Bank, Houston	Great Western Financial Corp., Los Angeles	(2)
UTAH		
American Investment Bank NA, Salt Lake City	Leucadia National Corp., New York	(1)
Great Western Bank, Salt Lake City	Great Western Financial Corp., Los Angeles	(2)
VIRGINIA		
Dimension Bank of Virginia NA, McLean	Dimension Financial Corp., Denver, CO	(1)
Great Western Bank, Falls Church	Great Western Financial Corp., Los Angeles	(2)

U.S. BANKS AND TRUST COMPANIES CONTROLLED BY NONBANK INTERESTS (Cont.d)

Bank	Parent Company	Acquired/ Formed
WASHINGTON		
Dimension Bank of Washington NA, Bellevue	Dimension Financial Corp., Denver, CO	(2)
Frank Russell Trust Co., Tacoma	Frank Russell Co. Inc., Tacoma	1980
Savings Bank Trust Co. Northwest, Seattle	Shearson/American Express Inc., New York	1970

(1) Chartered but not yet in operation.
(2) Charter application pending.
(3) Acquisition pending.
(4) In formation, charter application not filed.

A plus sign (+) indicates a revision.

Source: American Banker, April 16, 1985.

Recent State Legislative Developments on Interstate Banking

Recent state legislative changes pertaining to interstate banking cannot be grouped into a few neat categories. Diversity, though, has always been one of the features of the dual banking system. The following seven groupings appear to make sense in terms of the major similarities and differences but fall short of a definitive state-by-state comparison of the specific statutory changes.

1. Open Interstate (Non-Reciprocal) - Maine's interstate banking law dates from 1975 (effective in 1978) but has been amended several times since then. The latest amendment, which was in 1984, dropped the reciprocity requirement so that banks and holding companies in Maine may now be acquired by any out-of-state financial institution holding company. Alaska enacted its "open interstate" statute in 1982, and the Arizona statute was signed by the governor in April 1985.
2. Regional (Non-Reciprocal) - The Oregon statute, which was enacted earlier this year, permits non-reciprocal acquisitions by banks or bank holding companies from eight states as of July 1, 1986.
3. National Reciprocity - Until this year's national reciprocity law in Washington, New York had been in a category by itself with a law (1982) which permits acquisitions of banks by out-of-state holding companies if the home states of such companies have reciprocal statutes. Kentucky and Rhode Island, as explained below, will move into this category in 1986, and Nevada will move into this category in 1989.
4. Regional Reciprocity - Fifteen states, the largest number in any of these seven categories, have enacted laws which allow acquisitions by out-of-state holding companies if the home states of such companies have reciprocal statutes and are located within defined multi-state areas. Three of the states -- Connecticut (1983), Massachusetts (1982), and

Rhode Island (1983) — limit their region to the six New England states. Eight states -- Florida (1984), Georgia (1984), Kentucky (1984), Maryland (1985), North Carolina (1984), South Carolina (1984), Tennessee (1985) and Virginia (1985) — have defined different, though largely overlapping, multi-state areas. One state — Utah (1984) — has included eleven other western states in its region but has excluded California. The law in Idaho (1985) includes Utah and five other western states in its region. The Nevada law (1985) establishes a 12-state western banking region, excluding California. Indiana's 1985 statute permits reciprocal acquisitions by bank holding companies from Illinois, Kentucky, Michigan, and Ohio. In Rhode Island and Kentucky the regional limitations expire in mid-1986, so that these two states will shift to the National Reciprocity category at that time. The trigger date for national reciprocity in Nevada is January 1, 1989.

5. Limited Activities - Six states permit out-of-state holding companies or their subsidiaries to acquire in-state banks if the activities of the acquired organizations are limited to specified activities, mainly multi-state credit card operations, or do not result in competition with other in-state banks. Included in this group are Delaware (1981, amended 1984), Maryland (1983, amended 1985), Nebraska (1983), Nevada (1984), South Dakota (1980, amended 1983), and Virginia (1983, amended 1985).

6. Grandfathered Companies - Illinois (1981), Iowa (1972), and Nebraska (1963) limit acquisitions by out-of-state holding companies to a few such companies which had one or more bank subsidiaries in the state prior to specified dates.

7. Problem Banks -Ten states -- Arizona (1985), Idaho (1985), Illinois (1984), Kentucky (1984), Maryland (1985), Nebraska (1984), Ohio (1985), Oregon (1985), Utah (1984), and Washington (1983) — have passed statutes that permit out-of-state bank holding companies to acquire troubled in-state institutions under some circumstances.

Most of the state legislative changes affecting interstate banking have come rapidly within the past two to three years. Further legislative changes at the state level certainly seem likely within the next few years. National reciprocal bills are pending in California, Illinois, and Michigan, and regional reciprocal bills are pending in the District of Columbia, Illinois, Michigan, Minnesota, Nebraska, Ohio, Texas, West Virginia and Wisconsin.

The CHAIRMAN. Thank you, gentlemen. We are going to continue. There's a briefing for Senators at 11 o'clock, but we simply have too many witnesses who have come from too far and so I will continue until we have completed all of the hearing, but because of the necessity of some of my colleagues wanting to go to that briefing I will defer my questions until later and turn to Senator Heinz first.

Senator HEINZ. Mr. Chairman, I thank you and Senator Proxmire. I have just one question for the record and one which I will state. The question I want to address to Mr. Roberts who represents the bank holding companies.

STATUS OF BANK HOLDING COMPANIES

Last week, Mr. Roberts, Secretary Baker was testifying before the committee and he indicated, of course, that the bank holding company format was the best format that allowed a bank to engage in new or if you prefer untraditional activities, and he stated that the bank holding company arrangement allows subsidiaries to be completely separate from the bank.

When I raised with him the problem of Continental Illinois, where the entire bank holding company was the vehicle for bailing out Continental, he replied that the reason that was necessary to go through the holding company rather than through the bank subsidiary was because of the covenants that had been entered into between the holding company and its note holders with respect to the underlying bank.

As I understand it, those kind of covenants are not at all unusual. In fact, I am told that they are very commonplace with most bank holding companies having them, that they are needed in order to make the bank holding companies' notes sufficiently secure to be salable. Without the covenants that prohibit the bank usually the biggest assets of a bank holding company from being separated from the bank holding company, who would buy the notes of the bank holding company?

Mr. ROBERTS. Senator, very frankly, I'm not entirely clear on that specific arrangement with respect to Continental. Obviously, if a bank holding company is seeking capital, it has to make various covenants. I think the covenants that are normally made with respect to the issuance of the paper of a bank holding company are normally those related to safety and soundness. I know of nothing—there may be an issue that I'm missing—I know of nothing that would particularly involve the integrity——

Senator HEINZ. How many of your members have those kinds of covenants with respect to the bank holding company?

Mr. ROBERTS. Sir, I'm not sure. Are you talking about the covenant with respect to the operation of an individual bank?

Senator HEINZ. Covenants that would require that, in effect, that were any bank to get into some kind of financial difficulty with this bank holding company that we would have to go in and use the vehicle for some kind of rescue?

Mr. ROBERTS. No, sir, I don't think that's a very common thing at all. I know in our own situation when we have to go to the market the underwriters are looking to the strength of our total holding

company, but I know of no specific covenants that are designed to impact any individual bank, or its integrity, or its soundness, or its obligations to the public. I think it's the general strength of the holding company. I'm not at all familiar with what you're referring to.

Senator HEINZ. I think we will probably have to correspond with you and get more specifics. I do want to ask a question for the record to Mr. Edgerly who's representing the Reserve City Bankers.

Mr. Edgerly, on page 2 of your testimony you state that provisions to shield the FedWire and other related systems from unrelated risks must be included in any new legislation and I would like you to supply us for the record in writing, in order to save time, what unregulated risks you foresee or have in mind; and second, how those risks could in fact be diminished by this committee. I won't ask you to reply now.

Mr. EDGERLY. We would be happy to provide that for the record.

[The following information was subsequently supplied for the record:]

State Street

State Street Bank and Trust Company
225 Franklin Street
Boston, Massachusetts 02101

William S. Edgerly
Chairman
(617) 654-3110

August 2, 1985

The Honorable William Proxmire
United States Senate
Washington, D. C. 20510

Dear Senator Proxmire:

I am writing to respond to the question regarding payments system risk which you submitted for the record following the June 19, 1985 Financial Services Industry Hearing of the Senate Committee on Banking, Housing and Urban Affairs, at which I testified on behalf of the Association of Reserve City Bankers.

The key risk to the payments system is that the Federal Reserve, and indirectly the American public, could suffer losses if a depository institution were unable to settle its FedWire or private wire system position by the end of the day. When unregulated companies are able to use their own depository institutions to access the payments system, this settlement failure risk is increased. Such a depository institution can expose the payments system to whatever uncontrolled risks are inherent in its parent's unregulated business.

We believe that this problem should be dealt with by preventing an unregulated holding company, by which we mean a company not regulated to the same extent as a bank holding company or a multiple savings and loan holding company, from using any affiliated depository institution to process its payments.

I am enclosing a copy of my recent letter to Senator Heinz which contains a more detailed statement of our concerns in response to his request at the hearing. Attachment A to the letter contains a draft of proposed legislation. I am also enclosing two reports of our Association concerning risks in the payments system.

Sincerely,

WSE:E
Enclosures

State Street

State Street Bank and Trust Company
225 Franklin Street
Boston, Massachusetts 02101

William S. Edgerly
Chairman
(617) 654 3110

July 29, 1985

The Honorable John Heinz
United States Senate
Washington, D. C. 20510

Dear Senator Heinz:

Following my statement on behalf of the Association of Reserve City Bankers at the June 19 hearing of the Senate Committee on Banking, Housing and Urban Affairs, you asked me to identify what risks unregulated companies pose for the payments system and how we propose to deal with the problem. I am grateful for the opportunity to respond to this central question.

As I stated at the hearing, the Association of Reserve City Bankers, which represents 150 of the nation's major banking institutions, has made substantial efforts since 1982 to deal with risks in the payments system. We have worked closely with the Federal Reserve Board to develop operating procedures aimed at controlling risk. I am enclosing as background information two of our reports on this subject.

1. **The Payments System**

For background, it is useful to begin with a brief description of the payments system. The payments system is the means by which funds are transferred between payers and receivers throughout the nation. It is of fundamental importance to the functioning of the economy.

The cornerstone of the system is FedWire, an electronic communication and settlement system of the 12 Federal Reserve Banks, which handles over $360 billion in transactions daily and whose volume is growing at a rate in excess of 10% annually. Since the enactment of the 1980 Financial Institutions Deregulation and Monetary Control Act, all "depository institutions," as defined by section 19(a) of the Federal Reserve Act, whether banks or thrifts and whether or not federally insured, have had direct access to the payments system as users of FedWire.

Users of FedWire are constantly making and receiving sizeable payments; at any moment a user's sends may exceed its receives from others, overdrawing the Federal Reserve account of the sender. Nonetheless, the Federal Reserve gives irreversible funds to receivers. If the sender failed to cover its overdraft, because of lack of liquidity or insolvency, the Federal Reserve, and indirectly the American public, would become a creditor of the failed sending institution.

Large dollar payments may also be made over private systems, the most important of which is CHIPS (Clearing House Interbank Payment System). CHIPS is owned and operated by the New York Clearinghouse Association and handles over $300 billion per day on behalf of 138 participant banks. On peak days total payments handled by FedWire and CHIPS have exceeded one trillion dollars.

CHIPS transfers are settled on a net basis at the end of the day through accounts at the New York Federal Reserve Bank. If a bank failed to settle, other banks expecting payments might themselves be unable to settle. While the New York Federal Reserve Bank would not be required to cover the system obligations of the failed bank, it might still do so to avoid an ensuing chain reaction of bank failures. Again, it would be the Federal Reserve, and indirectly the American public, which would be put at risk from a settlement failure.

The Federal Reserve Board is requesting participants in the payments system to adopt voluntary limits on FedWire overdrafts and on net obligations to other participants, so-called bilateral limits and net debit caps. Our Association worked closely with the Federal Reserve Board to develop these measures. While these measures reduce risk, they will not eliminate it. Their effectiveness requires rigorous new operating procedures, heightened awareness of creditworthiness on the part of all users of the payments system, and ongoing monitoring as part of the regulatory process.

Given the importance of the payments system to the economy and the risks associated with it, the safety and soundness of participants is essential. The way participant risk is controlled is through regulation. Regulatory agencies limit the permissible activities of depository institutions and their holding companies. They examine, monitor and control capital adequacy, the riskiness of assets and liabilities, and operating procedures. Transactions between holding companies and their depository institutions are examined, monitored and controlled. In these ways, regulation makes a crucial contribution to the stability of the payments system. The problem is that such regulation does not apply to certain holding companies.

2. Risks which Unregulated Holding Companies Pose for the Payments System

A hypothetical case may help to illustrate the risks which unregulated holding companies pose for the payments system. Suppose a company which speculates in the stock market orders a bank that it owns to send a FedWire for $10 million to a party from which it has bought stock. If, as is often the case, the funds to be wired out are not in the parent company's bank account, the bank may incur an overdrawn account, or overdraft, at the Federal Reserve Bank for its parent's benefit. No independent judgment about the parent's creditworthiness is made. Assume that the holding company, which is in an unsound condition, becomes insolvent that day. It cannot pay its bank, and its bank in turn cannot pay the Federal Reserve. But the Federal Reserve has already made an irreversible payment to the seller of the stock. The Federal Reserve is left with a $10 million loss.

If the company which owned the bank were regulated, the likelihood of such a failure would be significantly reduced by examination and supervision.

As the hypothetical case illustrates, holding companies can transmit risk to their captive depository institutions through overdrafts, and this risk may then be transmitted by the depository institutions to the system as a whole. Unless holding company risks are controlled, through limits on activities and through examination and supervision, a captive depository institution can expose the system to whatever uncontrolled risks are inherent in its parent's unregulated business.

We make no assertion that holding company regulation eliminates risk but only that it reduces it. Reduction of risk is the primary rationale for holding company and bank regulation. Some relaxation of the current limits on bank holding company activities is under consideration and is justified, but some limits will and should remain, as will examination and supervision.

Nor do we assert that all unregulated companies are more risky than regulated ones. There are risky regulated holding companies and risky regulated depository institutions. Recent experiences in Maryland and Ohio bear this out. The proper response to that problem is not to abandon regulation but to strengthen it. There are also low-risk unregulated companies. But without an unwise expansion of regulation and control, it would be impractical to attempt to sift high-risk from low-risk firms throughout the economy. This is particularly true because such sifting, to be effective, would have to be carried out on an ongoing and continuous basis.

Due to the narrowness of the bank definition in the Bank Holding Company Act and the lack of controls on the activities of unitary savings and loan holding companies under the National Housing Act, unregulated holding companies can own depository institutions, and thus control accounts at the Federal Reserve Banks in the names of their depository institutions. In principle, such a depository institution need do little more than provide a wire terminal connected to a Federal Reserve account. Like the bank owned by the stock speculator in the hypothetical case, the depository institution might not exercise independent credit judgement in dealing with its parent. In some cases, its primary purpose could be to provide its unregulated parent with access to the payments system without the application of objective credit judgement.

3. **The Solution**

Although the House is still considering legislation, H.R. 20 as reported by the House Banking Committee would continue to allow unregulated companies to own depository institutions and thus participate directly in the payments system. For example, state chartered banks eligible for but not insured by the FDIC, which have access to the payments system, are not defined as banks and thus can continue to be owned by unregulated holding companies. The same would be true under S. 2181 as passed by the Senate last year. This may seem to be a small loophole, but for gaining direct access to the payments system, one small loophole is all that is needed.

The way to deal with this problem is to prevent an unregulated holding company from using any affiliated depository institution to process its payments. By an unregulated holding company, we mean a company which is not regulated to the same extent as a bank holding company or a multiple savings and loan holding company. This would cause unregulated companies to access the payments system through independent depository institutions. The system would be shielded from exposure to holding companies that are not regulated for safety and soundness. At the same time such holding companies and their affiliates would be free to access the payments system indirectly, and their owned depository institutions would be free to offer the full range of services provided by competing depository institutions.

Under this proposal only regulated holding companies would have direct payments system access through their depository institutions. The purpose of holding company regulation is to reduce risk through constraints on permissible activities, through examination and supervision, and through capital requirements. There are unquestionably risky regulated holding companies, but the proper response to that problem is to strengthen efforts at controlling that risk. There are also low-risk unregulated holding companies, but it is impractical for the government to try to determine which particular companies should be admitted to or excluded from access.

A draft of proposed legislation to deal with this problem is included as Attachment A. I appreciate this opportunity to expand on our concerns and on our proposal to deal with them.

Sincerely,

WSE:r

ATTACHMENT A

PROHIBITION ON PAYMENT ARRANGEMENTS

(1) No depository institution affiliate of an unregulated holding company may hold any demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties, or process payments for or on behalf of such holding company or any of such holding company's affiliates.

(2) For purposes of this section, the following definitions apply:

(a) the term 'depository institution' means any 'depository institution' as defined in Section 19(b) of the Federal Reserve Act (12 U.S.C. 461(b));

(b) the term "unregulated holding company' means any holding company which is not

(i) a 'bank holding company' within the meaning of Section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841); or

(ii) a savings and loan holding company engaged only in activities permissible for a multiple savings and loan holding company under Section 408(c) of the National Housing Act (12 U.S C. 1730a(c));

(c) the term 'process payments' means any use of depository institution, Federal Reserve Bank, Federal Home Loan Bank Board or other similar accounts for the purpose of receiving or sending payments from one party to another party;

(d) the term 'affiliate' means any company that controls a depository institution and any subsidiary of such company. The terms control, subsidiary and company have the same meaning as in Sec. 2 of the Bank Holding Company Act of 1956 (12 U.S.C. 1841).

Senator HEINZ. Mr. Chairman, thank you.

The CHAIRMAN. Thank you, Senator.

Senator Dodd.

Senator DODD. Thank you, Mr. Chairman. I thank my colleague from Wisconsin for allowing me to go ahead. I'm going to try and catch that briefing. I will try and come back for the remaining panel.

First of all, welcome to all of you. Let me ask a question.

I was responsible for the amendment on the regional banking issue, though many other people certainly supported the issue here, and many of you have suggested that you want to have a trigger on this proposal. Let me commend, by the way, the American Bankers Association for moving on that issue, away from a position which was basically opposed to the whole notion of interstate banking. I think that's a fine step forward.

One of the things we're often accused of here in the Congress of the United States is not using the States as laboratories and triggering things without really determining the wisdom of the move, and I think that criticism is well founded in a number of areas.

Why don't we find out what this experiment means before we decide already before it's occurred that we ought to lock ourselves in at the end of 5 years to moving to full interstate banking?

INTERSTATE BANKING

I'll tell you frankly I'm for interstate banking, moving in that direction. My inclination is and my thoughts are that that's where we ought to go, but I don't know the full import yet. I'd like to be able to use the experiment of the spawning ponds, if you will, of regional banking to determine whether or not that is in fact the correct approach to take.

Aside from obviously the interest of the large money center banks to have interstate banking yesterday, I'm somewhat confused as to why, without the knowledge, without the full understanding of what we're getting into, that we would lock ourselves in, having not used this experiment, and determine today that this is something we absolutely must have at the end of 5 or 3, or 4 years, whatever else.

Why not draw that conclusion at the end of that period of time or at least some point during that period of time rather than doing it before it's even got underway?

I would ask any one of you to respond to that.

Mr. ROBERTS. I would like to respond to that, Senator, if I may. In the first instance, I think because we now have a situation where the Federal Government is not using the States as laboratories but the States are going to be using their own laboratories to, in essence, determine ultimately a very important policy—which is in essence dealing with a system which is now truly nationwide. I agree with Mr. Backlund. We have interstate banking now. Unfortunately, it's not being participated in in a full way by commercial banks.

Fundamentally, it's simply not fair. I do not think it is fair for any State to have the ability to in essence red circle by its location another State; that's anticompetitive. I do not think it's fair and

just. As a practical matter, why would we as a regional bank in Tennessee favor this? It's very simple. Tennessee is contiguous with eight States. Four of those States have passed regional statutes. Four have not. One of those has passed a nationwide trigger. There are a myriad of inconsistencies in each State law, each designed to have some little angle or protection. Our regional bill also covers five other States that are generally within our region. Three of those have not adopted reciprocal legislation. We have included one but they have not included us. Some say foreign banks should not be counted as a local bank. Some say they should.

My point is, we have now evolved through deregulation and technology and the aggressive movement of nonbank competitors a nationwide banking system which now is being left to the States to determine.

Senator DODD. Let me throw another twist to this and then I'll stop. I appreciate that, but yet many of the people who represent the American banking community would also tell us that we are violating States rights if we close the South Dakota loophole.

Mr. ROBERTS. I think they are two different issues. We happen in our association to disagree with your position on the South Dakota loophole because our association has consistently advocated the dual banking system as a strong believer in States rights. That assumes the power of a State to charter banks and to grant the authority and powers under which they operate. And we believe that your amendment goes too far in that it sets the precedent of going against that very power.

Now as to the issue of interstate banking or acquisitions across State lines, our association has always carefully said that you attack that issue through the Federal law that already exists, the Douglas amendment, dealing with bank holding companies, and our position has always been that it should be bank holding companies having the opportunity to acquire other bank holding companies, and that has always been Federal law. The Douglas amendment has controlled and Federal law has always controlled that type of expansion and is no wise inconsistent with the powers of States to charter banks and authorize powers.

A State bank that chose not to participate in the interstate movement, under our provision, would simply not be a bank-holding company and would opt out of its own volition without any further legislative action needed.

Mr. CONNOLLY. Senator, may I respond to that because obviously we have a difference of opinion with my friend on the issue of interstate banking?

I think it's important for the record that I reiterate that the New England experiment contemplates nationwide interstate banking.

I think it's also important that we reiterate the fact that the regulation of banking by either the States or by the Congress isn't a constitutional right of the States. The Congress delegated the regulation of geographic structure of banking to the States in 1956 and we acknowledge that they can take it away any time they want. The regulation of interstate commerce is up to the Congress and that is Congress' role.

Having said that, I associate myself with your question, which is, the experiment started 2 days ago; why prejudge or preempt the

lessons that will be learned from the experiment by locking yourself in with a specific date at this time?

I think that it's entirely appropriate for the Congress to consider it after they have had a chance to view it. That's our position. Not that we're opposed to interstate banking. We think that this is a transition and we don't see—and if it turns out to be unfair to either the large banks, or the small banks, or the northern banks, or the southern banks, or the western banks, or the eastern banks, any time Congress wants to change it they have the authority to change it, and I'm sure they will.

SIZE OF NATION CREATES DIVERSITY

Mr. CAIRNS. Senator, I think your question really gets right at the heart of the diversity that we have because of the very size of our country. We just heard it said again that this is an experiment. I don't see it that way.

We have interstate banking. We have First Interstate that operates in 11 Western States with holding company structures in banks in all those States. We have a bank in California that operates branches, not holding company banks but branches, in three Western States. We have banks in the Midwest who operate in multiple States.

So while it is perhaps viewed by the people in New England as an experiment, in the West it's not an experiment any more. We've been down that path and we know what the ramifications are.

The reasons for the trigger requirement for those who support it very strongly include the cost that's involved in expanding and the need for planning.

For example, take the area of the western coast where I come from, Washington. If you intended to go in northern California and you were headquartered in Washington State, you would want to have representation in Oregon, and if you were going in northern California you would want to go all up and down 95 from the northern border to the southern border of Oregon State. That would lead to one plan.

On the other hand, if you knew you couldn't get to California but knew you could only go to Oregon, you might likely just stop at the northern border of Portland.

So what you will buy, how you will put your structure together, is a very, very important element in your overall planning, your cost, and the certainty of knowing that you can achieve your final objectives is important early on lest you make mistakes or create more inefficiency or spend more money than is necessary.

I remind you, every time somebody spends money for attorneys or anything else, that cost has to be borne by somebody and often it winds up being the consumer.

Mr. CONNOLLY. I guess I should clarify, Senator, that I am not proposing that there be no triggers. What I am saying is: Is it necessary to make a decision on a national trigger right now? And I would remind Mr. Cairns that the State of Rhode Island enacted a 1-year trigger because they felt that that would best suit their interests in their legislation and a group of States that enact legisla-

tion are free to have a trigger or not have a trigger or to adjust their legislation to meet their needs in any way that they want.

Mr. BACKLUND. Could I make one comment, please? I think one of the things we're forgetting is how this new system that's developing is going to affect the real people in the country, the average person. And after all, that's what our financial system is for. It's to serve the consumers, the farmers, and the small business people, the blue hairs, the blue collars, et cetera, and that's what we don't know.

For instance, in Ohio, where they have had a tremendous change in their system the last few years, there is tremendous resentment among a lot of small business people, a lot of consumers there, against the concentration that's taken place there after the fact, after they went ahead and permitted this concentration. That's what we need to observe and that's why Senator Dodd's observation is very advisable.

Mr. ROBERTS. Senator, could I comment again on the experiment?

Senator DODD. I've stopped asking. You can keep on. My time is up but yours isn't.

Mr. ROBERTS. Just one comment on the experiment. Obviously, in the Southeast, which has received a great deal of attention, this is an experiment. It is not, as Jim pointed out, in the Nation as a whole. But why not let the experiment work a while?

Well, within the past 2 days I think we have had two major mergers announced in the Southeast between two large organizations. I applaud this. I think the Supreme Court decision was good. I think the regional compacts are good. I am convinced when those organizations combine they will be better able to serve the region and I'm convinced that it's procompetitive and will be shown to be so and will be approved by all authorities as being procompetitive.

What I ask is the question: If it is procompetitive and if it is within the regional basis, then why isn't more competition and more activity of this nature, without restriction to who might bring that competition in, even better? What these banks are doing are positioning themselves very obviously and very properly for greater competition coming when we inevitably have, as everyone seems to agree we will have, nationwide interstate banking. And I think that's perfectly proper. But why not if competition is good, isn't more better. Do we want to end up with a system of large organizations that are better able to compete in their region and then build their wall and keep out further competition? It isn't good for the public.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Cairns, I'd like you to clarify if you would for us the ABA leadership position on banking legislation.

As I understand your position, you recommend a legislative package that links three elements—closing loopholes, new powers, and interstate banking.

Mr. CAIRNS. That's correct.

Senator PROXMIRE. On page 6 of your statement you say that any legislation to close the nonbank bank loophole must—you use the word must—must be accompanied by new powers and interstate banking. I'm a little unclear about what you mean by the word

must. I can understand the word should. But the word must implies that unless Congress sees fit to provide banks with all the new powers that you are requesting and unless we authorize interstate banking, that 45 percent of your members are opposed to—— the ABA is opposed to any legislation at all.

IN FAVOR OF LIMITED NEW POWERS

I am for limited new powers for bank holding companies, but if the votes are not available, isn't it important to close the nonbank bank loophole? Why would you want to see so many unregulated firms invade the banking industry simply because Congress didn't enact your full wish list?

Mr. CAIRNS. Senator, I think you must have been listening to some of our discussion. The words "must" and "should" were debated at some great length.

As I pointed out earlier, when you get 400 bankers into a room and you get into subjects as complex as the ones we are discussing, especially the interstate banking issue, you find that there are a great number of needs that are different around the country. The consensus was that at this point in time as we begin these debates that these issues should be looked at as a three-legged stool, or three issues that are tied together—the expanded powers, closing the nonbank bank loophole, and the interstate banking issue.

It was on that basis that 97 percent of the bankers voted for the three-part legislative package. When we got into some of the specifics, one of them being the interstate trigger issue, there was a majority vote on that. I think the fact that the House Banking Committee has already taken the action it has would suggest that there will be activity by the full House on the two-legged stool. The third leg hasn't been dealt with and that's the one we hope that, along with others, your committee will be able to take up.

I think you are the one that ultimately must decide whether it should or must include these three elements and we will have to react to your judgments on these matters. But if we had our way, we think that all of these issues should be linked together.

Senator PROXMIRE. But if you have your way, we'll have either no legislation, or we'll have three part legislation. Is that what you're telling me? You say a three-legged stool. If you don't have the third leg on the stool, whichever the third leg is, you don't want the two-legged stool and it's no good. It's an unusual stool or an unusual balance.

Mr. CAIRNS. There is no question it's a difficult balancing act.

The CHAIRMAN. If I could make a comment here, Senator, I don't think it's fair to characterize that three-legged stool as all they want. I guarantee you S. 2851 isn't nearly what they wanted. I must emphasize that it is a very limited bill with regard to additional powers and if I were still in the position of insisting on a much broader bill, which I would have liked to have seen in the Garn-St Germain bill—it would have been much broader than it was. S. 2851 is an evolutionary process, processing a little bit at a time, as my colleagues in the Senate and House finally wake up to what I have been saying for several years, that there's a revolution going out there and we're not keeping up with it, so you do the

best you can and take a little piece. That's why I'm taking such a hard attitude, Senator, that just closing loopholes is not sufficient. Particularly with some of the Supreme Court decisions now on nonbank banks, there is no great pressure out there.

If we back away from what I consider a very limited bill which could not have passed without Senator Proxmire's support and help through the last several years, we end up with a couple of loophole closers and the next year we get a couple of other loopholes that attorneys will have invented and we constantly deal the way Congress has normally dealt with these issues. Senator Proxmire was working on a broad bill before I ever got here, municipal revenue bonds, before I was ever a Senator.

I just wanted to dissociate a little bit from the opinion of them getting everything they want. Oh, no. S. 2851 isn't even close to what they would like to have in that whole broad context.

Senator PROXMIRE. Anyway, Mr. Cairns, your position is that if we can get the nonbank bank loophole and new powers, which is my position, and not interstate branching, which I oppose, you still wouldn't want to that legislation; is that right?

Mr. CAIRNS. Our position is that we need all three elements, yes.

Senator PROXMIRE. I know you need all three. The question is, will you oppose the legislation if we——

Mr. CAIRNS. Well, we think that it's likely that we won't be faced with that decision in light of the fact that it's already taking place. We already have the beginning of the bill in the House that deals with the nonbank bank loophole and interstate banking issues and one that, incidentally, comes pretty close to our position.

Senator PROXMIRE. Mr. Backlund, will you comment?

Mr. BACKLUND. Our principal priority is the nonbank bank closing of the nonbank bank loophole, so we don't think there should be anything about interstate banking in Federal legislation now because we don't need it. On powers, we would like to see some powers but it's not absolutely essential.

DIVESTITURE OF ALL NONBANK BANKS

Senator PROXMIRE. Mr. Cairns, on page 6 of your statement, you say:

> We would prefer that the loophole be closed completely by requiring the divestiture of all nonbank bank subsidiaries. But if that is not possible, the loophole should be closed not later than July 1, 1983.

It seems to me that's a curiously feeble statement compared to other parts of your statement where you say the Congress must pass new powers legislation. Reading between the lines, you're more or less conceding in advance the lobbying muscle of the owners of the nonbank banks and yet, despite all the pressure, the House Banking Committee failed by only three votes to require divestiture of all nonbank banks with virtually no lobbying from the ABA.

Why don't you redirect your lobbying resources toward getting the owners of nonbank banks out of banking instead of clamoring for an extensive laundry list of new powers, which everybody but the willfully obtuse know you're not going to get—at least not all

of them. The ABA could help to require divestiture rather than the inequitable grandfather approach in last year's bill.

Mr. CAIRNS. Senator, we have expended considerable effort on trying to make known the reasons why the nonbank bank loophole should be closed. I think to say that we have expended no effort or a minimum effort in that area does not reflect the tremendous effort that actually has gone forth. We believe the nonbank bank loophole should be closed and we worked very hard trying to see that that takes place.

As I said in my prepared remarks, we would like to have no grandfather clause at all. We think it's complete evasion of the law and it's inefficient and it should never have occurred in the first place. It's building a system of banking on a loophole that is inappropriate in every possible way and we would like you to close it without any grandfather of any kind whatsoever.

Senator PROXMIRE. I agree with that wholeheartedly. I'm delighted to hear you say that because I think with any kind of a grandfather approach you're going to have a nightmare of complexity in our system if you have some of these nonbank banks continue, owned by huge corporations. They're going to go on forever and it constitutes an unfair basis of competition. It may be impossible, and perhaps it is, to have no grandfathers, but I think that position in principle is absolutely correct.

Mr. CAIRNS. And that is our position and has been all along.

Senator PROXMIRE. Again assuming the Senate passes a bill similar to last year's bill, Mr. Cairns, the debate with the House conference will be over new powers versus a national trigger. If you could only get one, which would you prefer: new powers or the national trigger on interstate banking?

Mr. CAIRNS. You're not going to let me off the hook, are you? I continue to say, Senator, that we feel it's important that all three issues go forward and we think the actions that have already taken place in the House on the subject of a trigger and what happened in the Supreme Court indicates that interstate banking will go forward, we hope with a trigger. We hope that you will be able to authorize a broad list of expanded powers and close the loophole and we think based on what's happened already there's a reasonable likelihood that you will be able to come very close to our objectives.

Senator PROXMIRE. Mr. Roberts, what's your position on that? If you can get one, which would you prefer, the new powers or the national trigger on interstate banking?

Mr. ROBERTS. Senator, obviously our association prefers all of those things, too, but I would have to say that I have come to the conclusion—and I think our association has in our legislative policy committee—that this whole issue of geography is so divisive, so important and so critical now, that in all likelihood I don't think until we get that resolved in a progressive way we're going to be able to deal with powers.

Senator PROXMIRE. What I can't understand about that, Mr. Roberts, is I think we have the best banking system in the world.

Mr. ROBERTS. I agree with you completely.

THREAT OF CENTRALIZATION OF BANKING

Senator PROXMIRE. Well, what's the difference? The difference between this country, England, France, Japan, and the rest of them is that they have nationwide banking. They have five or six big banks which is what this is going to amount to eventually, in my view. The independent banks will be swallowed up as times goes on and our system has worked beautifully. You take a little town in Wisconsin and in that little town there's a bank, but there's another bank about 4 or 5 miles away and there's another bank about 15 miles away and there's all kinds of competition. I have been in the Senate for 28 years. I have yet to have anybody from Wisconsin come to tell me that the interest rates are noncompetitive or that the loans aren't made in a competitive way. We have terrific competition now.

We have it because we have 14,000 independent banks and we are not going to get that, in my view, if we have interstate banking and a bank in New York owns a couple of thousand banks around the country or a bank in Tokyo owns a couple thousand banks around the country. That's the nightmare that haunts me.

Mr. ROBERTS. May I respond, sir?

Senator PROXMIRE. Yes, sir.

Mr. ROBERTS. Well, I can certainly appreciate your concern, but I would respectfully disagree with you. And I think the concern is unfounded because there is no effort or thrust or desire on my part or this association or any banker that I know to try to develop a European system of national banking.

Senator PROXMIRE. That's what's going to happen though.

Mr. ROBERTS. I don't really think so, sir, because I think we have competitive viability in our system. I have been a believer and I've seen it happen many times not only in my own State but I've observed it in other States, with all the growth acquisitions and combinations even that we have now, the strong, well-managed, independent bank that really pays attention to its local community, that takes care of its relationships, is continuing to grow, to survive and to prosper in this environment.

In fact, I believe the record will show that even after all the consolidations we've had thus far that there are more independent banks today than there were 10 years ago and the concentration of deposits in the 10 largest banks is less than it was 20 years. And I think what we're talking about here is the continued ability of this kind of system to survive as against the new changes, the new technology, and the onslaught of the nonbank competition that we have. Frankly, I think that the idea is a bugaboo that a few large New York organizations are going to take over the world. When I look at the financial data and their capital and what it takes to acquire banks, particularly if you follow a Douglas amendment approach of a holding company acquiring a holding company, I think it's unrealistic. I think it's a bugaboo. Many banks in Tennessee—those small competitors in small communities that really pay attention to their services and products and customers can beat our heads in any time they want. I believe that, sir.

Mr. BACKLUND. I agree with that, except one thing you're leaving out of the equation is that bank stockholders are very often offered

big prices for their bank and the well-managed bank and the banker in that community who wants to serve that community has little to say about that when they vote to sell out. That's the thing you're forgetting.

Getting back to the other point, Senator, you were asking about the trigger and what their position would be. I'm sure that if the trigger was part of the bill the IBAA could not support it, regardless of what was in the bill otherwise. I wanted to make that clear.

Senator PROXMIRE. My time is up, Mr. Chairman.

The CHAIRMAN. Gentlemen, we have a lot of questions we will be submitting to you for your response in writing.

Let me just make a couple of comments as I sit here after 10 years of listening to a lot of comments that don't seem to change much. The faces change. The time changes. I still have to get back to the very distinct feeling I have in watching this whole process, that regardless of what you want or what you say you would like to have, whether it's two-legged stools or three-legged stools, whether we have triggers or whether we don't, it's going to happen. It's really rather academic arguments we deal with.

I don't favor a trigger. There won't be a trigger in my bill. It's not going to pass the Senate this year. I would be surprised—and I may be wrong—if the trigger passes the House. Politically, we are not ready to face up to the reality. I see no need to put a trigger in in any event. I don't care what number of years you put on, whether it's 5 or 7 or 3. I don't really think it makes a lot of difference. The Supreme Court has spoken on regional banking saying the decision we made in my bill last year. That will proceed. That is an evolutionary process by which full interstate banking will occur. It isn't a question of if; it is a question of when.

And if you look back a long time after I'm gone from the Senate and full interstate banking is here and a lot of things will have happened. It is already happening. If I could just get people in the financial services industry to move themselves back 5 years and see things that they were either for or against, and regardless of that opposition or favoring certain pieces of legislation have taken place.

We operate in a very diverse financial community in this country that is becoming international in scope. And although Senator Proxmire and I agree on the issue of triggers and interstate banking as far as going to full interstate banking—there's no disagreement there—I don't share his view of what will happen. We are too ingenuous. We are too innovative in this country and we are too uncentralized to ever have a European system of banking. I'd be willing to bet you if we passed a full interstate banking bill tomorrow that in the year 2000 we would still have 10,000 banks at least in this country or financial institutions. Because in New York, Citicorp hasn't sopped everybody up and Bank America hasn't and your State hasn't ripped off my State, and they aren't any bigger than Walker Bank & Trust. I'm sure my friend from St. George will indicate that Dixie State Bank is not a very large bank but First Security hasn't run him out of business and neither has Zions or Commercial Security Bank. They are there and they have branches all over the State. But we've sure got a lot of good independent banks in my State. If they are well run, well managed,

and innovative, they will survive. Mr. Hickman is going to survive and he will beat Citicorp if they come into the State.

NEED TO FACE REALITIES

I just wish some way we could start to face the realities of what is taking place and I hope that you won't turn tail on some of these things. It is so easy and I've seen it happen over, and over, and over again when we try to do something and move forward with positive legislation and then at the end we take a crumb, we always take a crumb. The ABA has done that to me before. It's gotten weak-kneed before and said, "Oh, we can't get this so we back out."

What I'm saying is don't get weak-kneed, any of you, regardless of what you represent, and settle for a couple of loophole closers.

Well, 10 years of testimony, legislation, and work and a marketplace that is in a revolutionary state because of technology, and it will continue to evolve even more rapidly than any of us guess. Meanwhile, out of this you come up with positions in your debates and when it's all said and done you'll take a nonbank bank loophole closer. You've got nothing because the marketplace still changes and there will be a new loophole tomorrow. Just go back—forget the future, just look at the past and see what has taken place. We've got nonthrift thrifts. That's a new one. I hadn't heard of that until Volcker testified. But when we're through with nonbank banks and nonthrift thrifts and non-non nons or whatever it is, we've got bright people and a diverse system out there and the Sears of this world, the Merrill Lynches, the banks, and the savings and loans, and all of you are going to be out there trying to figure out how to make a buck. You're going to have that light turn on and say, "Aha, we found a new one."

Until this Congress gets away from defensive, simplistic legislation and responding after the fact, it won't make any difference who's chairman here or who's in this body or who's here in the year 2000. We'll be playing the same old game. And there isn't one of you in business—I don't care what business you're in—banking, or insurance, or anything else—who can operate the way the U.S. Congress does—always behind the power curve, always operating defensively and politically and never trying to take the long view of it.

Well, I don't have enough time in life to sit around and use whatever intelligence I have to devise a nonbank bank loophole. That's so easy to do. That doesn't take any legislative skill. It doesn't take any legal background. It doesn't take any more than common sense just to do that. It does take a little more work to try and visualize what's going on in the marketplace and look down the road and I certainly don't want to indicate by saying that that what I write in my bills is the only solution. I've never been dogmatic or one that says I have a bill in that has to pass because I want it to pass. It's not that at all.

I don't know exactly what the system should look like 10 years down the road and even if I did I wouldn't try to impose it on the financial services industry. I'm telling you I'm getting more and more frustrated to sit through years of hearings and arguing the

same debate with the selfishness and greed between the different parts of the industry and when it's all said and done, we pass a couple loophole closers.

So I'm not satisfied with that. If I had been satisfied in 1982, we wouldn't have had any deregulation at all. We would still be bound with interest rate ceilings and so on because the pressure was incredible for me to do title I and title II which was the new regulations bill and the thrift certificates bill bailout for the thrifts and that's all we would have had if I hadn't been hardnosed and said, "No, that isn't good enough."

So whatever you people want to do—and the rest of you who are going to testify—if you want to sit back and bail out for a crumb, fine; that's your choice. But I don't intend to sit here hour after hour, year after year watching the marketplace in which you don't have to have too much intelligence or banking experience to see—the consumers know what's going on—the dramatically changing industry that is noncompetitive in some aspects because of Government rules and regulations that give certain segments of the economy an advantage over others. That is a very basic and fundamental problem. That is all I am trying to do, to try in some measure take those inequities out that are caused by Government. And then if one of you can beat a competitor to death and put him out of business, so be it, or they can put you out of business, as long as you're playing by the same rules.

That means functional regulation, too, so that you're not just given the same powers but then create other inequities because you're regulated differently.

SETTLE FOR CRUMBS

Well, I didn't intend to get into such a long lecture, but it gets a little bit frustrating when we're willing to settle for crumbs. And if it was hard to see what was going on in the marketplace, then I could understand indecision, be cautious, and so on. But, boy, the turf battles that are going on and will continue to go on—I suppose I'm rather naive—of somebody trying to protect their own piece of the turf rather than being willing to compete on an equitable basis—that's part of it. Some people in the industry don't want a level playing field. They don't want to even get close to it because they are afraid maybe they can't compete if it's all fair. The Government is giving them a little profit here. Just like many of the institutions under regulation, you didn't have to be too bright to run an institution. The Government told you where you could lend it, particularly in the thrift industry, so much in this basket and so much in that basket, and you can only pay 5.5 percent. What decisions did they have to make when they came to work every day? The Government was telling them what to do.

I hope we won't settle for a little piece of the pie and so on. I frankly think that no legislation is better than just going for a couple of loophole closers. We could have done that 2 years ago and saved everybody's breath, and then we would have been addressing—I suppose we wouldn't have because we would still be holding a hearing today on what to do with the new loopholes.

Gentlemen, we appreciate your patience and your willingness to be here today.

[Responses to written questions from the committee of B.F. Backlund, Kenneth L. Roberts, Morgan B. Stark, James G. Cairns, Jr., William S. Edgerly, William J. Connolly, Jr., and John W. Hickman follow:]

B. F. BACKLUND, President, Independent Bankers Association

Questions for Mr. Backlund from Senator Garn and Answers to these Questions

(1) In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Why?

(1) The IBAA does not subscribe to the inevitability doctrine. Congress drafted legislation which is clear and precise drawing lines of separation; recent court cases have upheld these lines. Congressional drafting decisions play a very important role in determining what will or will not happen. The IBAA continues to champion the separation of banking and commerce. The blurring of these lines increases the exposure of the U.S. Government and the taxpayer since there is a potential liability in FDIC insurance and in the Fed's lender of last resort role.

(2) Should Congress authorize joint ventures among and between participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

(2) Banks in small towns and bank holding companies with assets of less than $50 million are already authorized to offer general insurance activities. Discount brokerage activities are already permitted for banks. We are comfortable with the procedures under the Bank Holding Company Act whereby the Fed decides what are the permissible, financially-related activities for banks. The Fed has been sensitive to safety and soundness concerns. We see no need for the Congress to authorize "joint ventures" among and between participants in the banking, insurance and securities industries.

(3) Many analysts claim that commercial and personal loans are in the process of being "securitized." They point to commercial paper, mortgage backed securities, auto loans, and junk bonds. Do you agree?

(3) Yes, there is undoubtedly a trend towards insured institutions packaging and selling off loans they have originated. Many community banks are actively making SBA loans and selling off the U.S. Government insured portion to other investors. We look upon these practices as positive developments in that they can bring outside capital into a community.

However, we have a serious concern in this area when insured institutions, particularly larger money center banks who are too large to fail, originate, package, sell and service large quantities of individual loans not insured by the U.S. Government, but which are perceived by the unsophisticated investor as having an explicit or implicit guarantee from the originating insured institution. This would put the originating bank's capital under greater risk and thus the FDIC/FSLIC might, ultimately, be called on to cover this liability. This, along with all off-balance-sheet liabilities, should be part of your future considerations regarding federal deposit insurance reform.

(4) It has been reported that foreign banks now originate more than 40% of the commercial loans to U.S. domestic corporations in the New York market. Is this true? If so, why?

(4) Foreign banks are active in the U.S., and American banks are very active overseas. As regards foreign bank operations in the U.S., knowledgeable observers now indicate "that the growth rates achieved by foreign banks in the last decade cannot be extrapolated into the future...Indeed, it is important to recognize that in several important respects, an era has ended in the history of foreign banks in the United States", (The Bankers Magazine, May/June 1985, pgs. 18-19).

The July 15, 1985 issue of Business Week points to the major thrust of Citicorp to better penetrate the Western European retail banking market. Latin America used to be a major profit center for American money center banks. Perhaps if larger American banks had been doing a better job at home, foreign bank penetration would have been less. Perhaps American banks were too eager to chase a higher yield in Latin America and their domestic lending activities suffered as a result, opening the door to foreign bank penetration. Community banks have one overriding purpose--to provide financial services to their local communities. With a few exceptions, we are not aware of major foreign banking interest in the areas we are serving.

(5) In his testimony James McCormick, President of First Manhattan Consulting, indicated that capital and reserve requirements coupled with having to pay market rates on deposits is beginning to make the traditional bank profit formula obsolete. Do you agree? Why or why not?

(5) We applaud the efforts of the regulators, led by Chairman Isaac, in recent years to equalize required capital ratios. This has been a major step towards fairness. Because traditional profit formulas are changing, it is unwise for bank regulators to raise capital requirements at this time. Most of our members, due to their size, are simply not in a position to raise subordinated debt.

A diversified loan portfolio is not always a source of strength. Oil patch and LDC loans did not help Continental Illinois. Reserve requirements are a tax but let us remember that in the historic Depository Institutions Deregulation and Monetary Control Act of 1980, taxes for the largest banks of this nation were cut substantially while taxes for many banks which were not members of the Federal Reserve System were increased. Interest rate deregulation has made asset liability management considerably more difficult, profits are harder to come by, traditional spreads are harder to maintain and, yes, banks need new profit centers.

(6) The legislation which passed the Senate last fall provided for a very modest expansion in the range of services that banks could offer their customers, but it was a step in

the right direction. If banks are not authorized to broaden the services which they can offer:

a. What will be the impact on banks' ability to maintain expensive brick and mortar facilities for the convenience of consumers?

b. What will be the impact on the ability of the industry to raise capital and what will be the impact on the riskiness of the industry?

(6) The modest expansion of powers contained in the legislation which passed the Senate last year was of little use to your average community bank. As I mentioned in my formal testimony there are new "powers" that would be more beneficial to community banks such as brokerage powers for the sale of real estate, insurance and securities, and the authority to manage money market mutual funds as recommended by Secretary Baker. Expansion of the range of services that banks can offer will have a beneficial impact on the overall financial condition of the banking industry by diversifying risk and expanding a bank's customer base.

Broadened services per se will not determine banks' ability to maintain brick and mortar branches. Banks' profitability is a function of interest rate spread, economic conditions and, what services are being offered. The proliferation of automated teller machines is far more influential, I believe, in holding down the cost of brick-and-mortar banking.

If we are not allowed to broaden the services we can offer, if our spreads continue to narrow--this will impact adversely on the traditional services we have been offering and make it more difficult to raise capital. It will adversely affect the safety and soundness of the banking industry.

(7) I know your group has had a long term opposition to interstate banking. But recent studies have shown that interstate banking is really here, through the auspices of chain banking. Would you advocate divestiture of banks held by a single individual or group of individuals in more than one state? How do you distinguish this phenomenon from ownership across state lines by holding companies?

(7) Chain banking and interstate banking are two separate issues. In recent years, the major interstate banking movement has been the state authorization of regional compacts with a few states authorizing unlimited entry. Interstate banking has also received a major impetus from financial instability and institutional failure. Failed banks and failing thrifts have been a major factor forcing states to make decisions permitting out-of-state entry which they wouldn't have permitted otherwise. It is an unfortunate fact of life that interstate banking is moving forward on the back of financial instability and based on the theory that breaching interstate barriers to permit these takeovers is superior to more expensive rescue efforts in which loan portfolios are cleaned up and institutions are sold to in-state buyers. It remains to be seen whether this policy which led, for example, to Citicorp's penetration of Illinois, California and Florida proves to be in

the best interest of our nation's economy. Ten years from now, it could make the nationalization of a major holding company that much more expensive.

Chain banking, on the other hand, is not a significant phenomenon in terms of deposits controlled by any one individual. A chain banker cannot generate the kind of leverage or financial power that a holding company can generate. We are concerned about the economic and political effects of economic concentration, and we do feel there is a striking difference between an individual owning a $10 million bank in one state and a $16 million bank in another, and the largest holding company in one state owning the fourth largest holding company in another.

We do not recommend the divestiture of existing banks other than nonbank banks. Those pursuing the nonbank bank option knew they were taking a risk--they knew they were skirting the edges of existing law. They should not be rewarded.

(8) Mr. Roberts points out in his written testimony that it would be folly for a holding company to acquire a bank and turn its back on that community in lending or in other ways. Would you care to comment on that thought?

(8) An out-of-state bank may not have community service in mind when it acquires a bank in another state as a toehold in an ambitious expansion strategy. Many states realize this

when they impose job creation or other criteria as a condition for allowing out-of-state banks to enter their states. In our judgment, individual community considerations will always play second fiddle to the overall corporate investment strategy of large financial institutions. Larger banks could very well seek to enter a deposit-rich suburban market looking towards channeling local deposits into large corporate loans elsewhere.

R. F. BACKLUND, President, Independent Bankers Association

ANSWERS TO SENATOR D'AMATO

(1) The Glass-Steagall Act was viewed by its proponents as an integral part of the effort to restore public confidence in the banking system after its collapse in 1933 and to protect depositors by insuring the stability of commercial banks. In particular, the Act's substantial separation of commercial and investment banking was designed to eliminate the problems and abuses Congress believed were associated with commercial banks' securities activities.

Do you believe the Act was too sweeping and that the problems it was meant to solve could be addressed with other legislation? Would this enhance the banking industry? Would the consumer benefit?

(1) We support the contention of Chairman Garn and Senator Proxmire that certain securities powers are too concentrated and that substantial public benefits would accrue if banks were allowed to carry forward certain functions which have been reserved for the securities industry such as underwriting revenue bonds, commercial paper and mortgage-backed securities. We do not believe that the securities industry should be permitted to invade the deposit-taking function, one of the traditional realms of banking. We regret that money market mutual funds are not covered by reserve requirements and that banks and thrifts alone must bear this tax which is essential to the conduct of our nation's monetary policy.

We do believe that if breaches in the wall separating commercial and investment banking are to be made, they should be made by decisions of the Congress and not by innovative regulators exploiting loopholes in existing laws.

(2) Those who oppose the affiliation of banks and securities firms maintain that conflicts of interest resulting from such affiliations justify the preservation of the Glass-Steagall Act. Banks have long faced potential conflicts of interest, particularly between their commercial lending and trust activities. Securities firms face comparable potential conflicts in their various roles as underwriter, broker, dealer, and investment adviser.

Do you believe that divorcing the two, because of potential conflicts, imposes unnecessary costs on society?

(2) No. Conflicts of interest can never be fully eliminated. But it is in the interests of the system and of the consumers it serves to strive to prevent and eliminate abuses.

(3) In recent months there has been a growing number of bank failures throughout the nation. In some states entire bank systems have come under suspicion. It seems each time a small bank faces financial trouble, a large out of state bank moves in. When an entire system fails, as was the case in Ohio, large interstate banks move in to straighten out the situation.

For all practical purposes, interstate banking is proceeding, despite the lack of Congressional action on the subject. I am hoping that as financial experts you could provide additional insight into this matter. Do you believe consumers will benefit? Will interstate banking provide safer banking?

(3) The IBAA is convinced that interstate banking will result in larger banks and fewer banks--meaning fewer competitive units down the road. Ultimately this will increase the risk to and exposure of the U.S. Government. We neglect the lessons of Continental Illinois at our peril. Unfortunately since Continental, we have a two-tiered banking structure in this country: the very large banks which are fail-safe and the thousands of remaining financial institutions which face the ultimate market discipline--the privilege of failing. If the money center banks who participated in the interstate rescue

missions were required to accurately classify their loans in Brazil, Argentina, Mexico, etc., as we are required to classify our troubled agricultural loans--would their capital levels have permitted these out-of-state takeovers? Are we creating healthier, sounder institutions or are we beginning to take major steps which eventually will lead to the nationalization of the banking industry since the growing Government involvement and stake in giant money center institutions must be protected?

The U.S. Treasury and the Federal Reserve already play a major role in protecting the loan portfolios of the money center banks as they relate to LDC debt. Your appropriation of funds to the IMF helps them play this role. The FDIC insures all the depositors and creditors of money center banks as the actions in the Continental Illinois case demonstrate. And with these extraordinary support systems in place, a small percentage of banks in this nation want the right to roam where they wish. No, the consumer of financial services and the taxpayer will not benefit.

Maybe the high degree of Government involvement on both the asset and liability side of the ledger makes the fail-safe money center banks safer, but is this the way we want our banking system to evolve? Do we want ever greater Government control and involvement in our banking system? The IBAA does not. We urge the Congress to address this fundamental issue before they make up their minds on interstate banking. It is very hard for the small bank or thrift in Peoria, Illinois to

offer the rate of deposits that Continental Illinois can offer. But then we don't receive any cut rate money from the Fed discount window which we can blend with the money we purchase at market in deciding our loan rates. I also cannot assure the depositors in my bank holding more than $100,000 that they will be made whole if my bank fails. Is Continental offering safer banking?

B. F. BACKLUND, President, Independent Bankers Association

ANSWER TO SENATOR PROXMIRE

If this Committee were to close the nonbank bank loophole in a satisfactory manner while at the same time providing for a national trigger for those states participating in regional banking arrangements, what would be your position on the legislation? Would you still support it, or would you lobby for no bill if the price of closing the nonbank bank loophole included a national trigger?

We very much regret that legislation closing the nonbank bank loophole is being held hostage today as it was held hostage in the last Congress. We regret that hundreds of thousands of dollars of our small budget has had to be spent to take this issue to the courts because the Congress failed to act. But the courts have acted to uphold the law and because of the courts, the nonbank bank movement is on the decline. We still hope Congress will finish the job the courts have started by permanently and legislatively closing the nonbank bank loophole.

We cannot support any legislative package which contains a national trigger for those states which voted to enter into a regional banking arrangement. To do so would be to ignore the states' rights policy which has been our hallmark and a stated goal of this Administration. The states which voted to become part of a regional compact did not elect to become part of a nationwide interstate network. Yet that is the decision which a nationwide trigger would be forcing upon them. A nationwide trigger would additionally reward the banks which sought to exploit the nonbank bank loophole, which is curious justice indeed.

Questions for Kenneth L. Roberts, Chairman, Association of Bank Holding Companies relating to Financial Services Industry Hearing, June 19, 1985. From Chairman Garn.

Q. In your opinion, is the continued blurring of the lines between banking, insurance and securities inevitable? Why?

Answer. The answer to this question turns on the definition of "banking" and what decisions this Congress makes vis a vis "nonbank banks" owned by financial and non-financial conglomerates. As I indicated in my statement (p. 14), the Bank Holding Company Act was intended to have maintained the separation, but because of the way the definition of "bank" has been altered over the years, the stated objective has not been achieved. Congress therefore faces the difficult questions of whether securities firms, insurance companies, retailers, finance companies, and the like should be allowed to own banks, and, if they are, whether these firms should be treated as bank holding companies.

As you know, Federal Reserve Board Chairman Volcker strongly supports legislation to restate the demarcation so that a "bank" basically may be owned only by a company registered with the Board as a bank holding company. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, has made the argument that any company that issues, or has the capability of issuing, transaction accounts, should be a bank holding company. If this policy view were to be adopted by Congress, there would be a clear distinction in the law regarding firms that offered third-party-payment services to consumers -- i.e., they would be "banks" for all intents and purposes, and there would not be any blurring of the distinction regarding checking accounts as there is today.

In light of these considerations, I made the comment in my statement, that when all is said and done, it may make sense for Congress to consider broadening the Bank Holding Company Act to encompass all companies that wish to offer bank-like services. In this way, regulation and supervision of the banking functions of these entities would be uniform, rather than haphazard, as it is today. This would have the additional beneficial effect of systematizing the asset side of company balance sheets, avoiding today's predicament where only bank holding companies are severely restricted in the types of asset powers available to them. Presumably, under a broader law, bank powers would be

broadened, and nonbanking firms' overall scope would be lessened, as considerations of depository safety and soundness were applied across the board to companies offering deposits or deposit-like instruments to consumers.

Q. Should Congress authorize joint ventures among and between participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

Answer. There is no inherent reason why this should not be done. Currently, the most common activity susceptible to specific authorization is the joining of insurance sales at bank branch sites. There are undoubtedly other types of ventures that could be tried, such as securities products, and there is no economic reason not to, so long as standards of safety and soundness, fair competition, and public benefits are maintained.

Q. Many analysts claim that commercial and personal loans are in the process of being "securitized." They point to commercial paper, mortgage-backed securities, auto loans and junk bonds. Do you agree?

Answer. I have no special knowledge in this area. We have supported congressional efforts to allow bank holding companies, through subsidiaries, to underwrite and deal in mortgage-backed securities. My impression is that the success of this type of security is leading to experimentation in other areas. I have no idea how far this trend will go.

Q. Commercial banks in London, including affiliates of U.S. banks, can engage in a broader range of investment banking activities than commercial banks in the U.S.

a. Are you aware of serious safety and soundness problems that have arisen from these activities in London? Conflict problems? Why or why not?

b. Does a financial institution operating in London have a competitive advantage over one operating in the U.S.? If so, have banks in the U.S. lost business to English affiliates and competitors?

Answer. First, I must state that my perspective is that of a regional banker located in Nashville, Tennessee. Having said that, I would venture the following impressions.

First, I am not aware of any safety and soundness problems going beyond the usual concerns that exist in the U.S. Someone more knowledgeable in this area, such as an official of the Bank of England, may well wish to advise you on this.

Second, there is no doubt, based on conversations I have had with my colleagues at money-center banks, that overseas banks do have significant cost advantages. They do not have reserve or capital requirements to the extent we do, they do not have to own Federal Reserve stock, they do not pay deposit insurance premiums -- all of which add to the costs a U.S. bank must figure in to loan rates it quotes to customers. As a result, it is frequently the case that a foreign bank can offer a good bank customer a better rate on a loan.

Q. It has been reported that foreign banks now originate more than 40% of the commercial loans to U.S. domestic corporations in the New York market. Is this true? If so, why?

Answer. Again, I have no special knowledge to equip me to answer your question. I would recommend that you ask the New York Clearing House Association to comment on this matter, since its members have the experience to provide specific data. However, given the cost advantages I mentioned in connection with your previous question, it would not be surprising to learn that a substantial proportion of the commercial loans to U.S. domestic corporations is made by foreign banks.

Q. In his testimony, James McCormick, President of First Manhattan Consulting, indicated that capital and reserve requirements, coupled with having to pay market rates on deposits, is beginning to make the traditional bank profit formula obsolete. Do you agree? Why or why not?

Answer. It has become much more difficult to manage liabilities since the ceilings authorized by Regulation Q were removed. Moreover, when that is coupled with the renewed insistence on the part of the regulators in having adequately capitalized holding companies and banks, there is no question that bank operations are more challenging today. Profit opportunities must be sought out, and analysis of credit risk becomes even more important than before. Frankly, I am concerned that, given the statutory rigidities bank holding companies encounter today, our member companies will find it more and more difficult to earn reasonable profits. That is why I so strongly emphasized in my oral statement that interstate banking is the issue in banking today. It must be resolved for two reasons. First, to provide bank holding companies with the flexibility they need to meet the expanding demands of their customers. Second, because it will not be possible for the industry to unite in a drive for additional product and service authority until the interstate issue is resolved. And we need both -- geographic expansion and additional product and service authority -- to be profitable in the late 1980's and beyond.

Q. Why should bank and thrift holding companies be given authority to underwrite and distribute mortgage-backed securities, particularly in light of Bank of America's problem in this area?

Answer. There is an element of risk in any banking activity, and it is my belief that the underwriting and dealing in mortgage-backed securities is a manageable risk. I am pleased that Chairman Volcker shares this view, as the Board has similarly supported this addition to the types of securities a bank holding company subsidiary may underwrite. I have no special information on the problem encountered by Bank of America, and therefore I do not believe it appropriate for me to comment on this specific situation.

Q. The legislation which passed the Senate last fall provided for a very modest expansion in the range of services that banks could offer their customers, but it was a step in the right direction. If banks are not authorized to broaden the services which they can offer:

a. What will the impact on banks' ability to maintain expensive brick-and-mortar facilities for the convenience of consumers?

b. What will be the impact on the ability of the industry to raise capital and what will be the impact on the riskiness of the industry?

Answer. We appreciate very much the constructive steps embodied in the products and services authority contained in last year's "Garn bill."

As I indicated in response to an earlier question, bank costs of doing business are already high. Branches are now high-cost means of delivering services. One way of covering these costs is by introducing complementary products and services that can be sold in the branch along with the services now available. This, as much as anything, accounts for the experiments going forward today in the area of banks' leasing space to insurance agents. Our member companies are experimenting with ways to increase fee income -- thereby strengthening the financial performance of their firms.

Without the addition of new product and service authority, it is inevitable that many more branch offices will be closed. It is incumbent on consumer activists to recognize the direct connection between costs and branch closings. If their aim is to have bank branches remain in various areas, then they must also support efforts of banking to obtain additional powers, such as insurance, to offset the costs of maintaining branches.

Investors look for profit opportunities. It is possible to attract investors to individual companies when they are convinced that the company's prospects are good. We need to assure investors that this in fact will be the case by running well-managed institutions and by seeking new areas for profit growth. If new areas are foreclosed to us, there will be a temptation to take on higher-risk assets in an effort to beef up profits. The alternative is to watch profits decline in relation to equity. The recent example of what several savings and loans have done by taking on excessive risk is a lesson in what can happen. I believe bank managements are better positioned to avoid excessive risk-taking, but there is no doubt the pressures are there and need to be resisted. The best solution is for Congress to allow geographic and product-and-service expansion within the bank holding company format.

Q. In your testimony, you discuss the success of the 1970 amendments to the Bank Holding Company Act in preventing tying. If changes were made in Glass-Steagall, or as banks become active in other sectors of the financial services industry, what effect would a tandem sales provisions, like that adopted by the House Banking Committee relative to nonbank banks, have on competition, assuming it applied to everyone involved in the banking business?

Answer. Perhaps I misunderstand the intention of the House sponsors, but my impression is that the tandem sales restriction would apply only to non-banking companies -- such as unitary savings and loan holding companies (e.g., Sears, Roebuck & Co.), as a means of drawing a distinction between banking and commerce. It would not apply to bank holding companies. (We already have a "tandem sales limitation," better known as section 4(c)(8) of the Bank Holding Company Act. We are very familiar with it, having been subject to it or its predecessor since 1956.)

The best solution, it seems to me, may be to develop a broader holding company statute that will apply to all firms offering bank-type services, something I alluded to in response to your first questions.

Kenneth L. Roberts, Chairman, Association of Bank Holding Companies

Answers to Questions of Senator Proxmire following Financial Services Industry Hearing, June 19, 1985

Concentration Limits

Q. The House bill on interstate banking would prohibit interstate acquisitions on the part of bank holding companies with more than one percent of total domestic deposits. It would also preclude mergers among the top 25 bank holding companies. What are the views of your association on these limits? Do you support them, and would you support the House measure if they are left in the final legislation?

Answer. The Association of Bank Holding Companies does not support the concentration limits in the bill reported by the House Banking Committee. We are working to change or -- preferably -- eliminate them.

With regard to overall antitrust standards, the Association sees no reason to treat banks and bank holding companies differently than other corporations. Indeed, it is increasingly difficult to define "banking." Securities firms, insurance companies, and retailers have all entered the traditional province of "banking" in the last decade, while thrift institutions have obtained bank-like powers and more. There is no such thing anymore as a "banking" market; therefore, it is impossible to equitably apply any mathematical formula to limit bank expansion.

Furthermore, any indice chosen -- such as insured deposits or bank credit -- will not give an accurate picture of a market. Insured deposits will pick up thrifts, but leave out various types of insurance policies that have savings features, money market mutual funds, and securities firms' cash management accounts, as examples. If a credit indice is chosen, loans made by insurance companies, finance companies, commercial credit firms, and the like will be missed. Thus, a true picture of actual market shares cannot be obtained using the crude data available to analysts today.

Q. Both you and James Cairns (ABA) conclude that deregulation has been a positive force and you recommend that Congress continue to deregulate the banking industry. You both argue that there is really no other choice. Would your position on continued deregulation extend to include lifting the prohibition on interest on demand deposits?

Answer. Yes, provided that this were accompanied by meaningful additional authority on the asset side of our companies' balance sheets to offset the additional costs. So far, Congress has focused on liability-side deregulation. Attention is needed on the asset side. Once this is accomplished, then there is no reason to retain the prohibition on the payment of interest on demand deposits. We do not regard the powers contained in last year's "Garn bill" as adequate to justify this action, however.

Kenneth L. Roberts, Chairman, Association of Bank Holding Companies

Answers to Questions of Senator D'Amato following Financial Service Industry Hearing, June 19, 1985

Q. The Glass-Steagall Act was viewed by its proponents as an integral part of the effort to restore public confidence in the banking system after its collapse in 1933 and to protect depositors by insuring the stability of commercial banks. In particular, the Act's substantial separation of commercial and investment banking was designed to eliminate the problems and abuses Congress believed associated with commercial banks' securities activities. Do you believe the Act was too sweeping and that the problem it was meant to solve could be addressed with other legislation? Would it enhance the banking industry? Would the consumer benefit?

Answer. The Association of Bank Holding Companies has strongly supported the initiative of President Reagan and the Treasury Department in past years to broaden the types of securities powers that bank holding companies may offer through separate affiliates. With this approach, the concerns embodied in the Glass-Steagall Act can be met without placing undue restrictions on the flexibility of bank holding companies. The additional product and service authority provided for in the Administration's initiative would enable individual bank holding companies to respond to consumer demands in the marketplace and compete with the essentially unregulated firms such as Merrill Lynch, Sears, Prudential-Bache, Shearson/American Express, all of whom are mounting aggressive banking - insurance - securities marketing efforts.

The securities industry is heavily concentrated, as recent data has disclosed. It is axiomatic that in a concentrated industry, buyers have fewer choices, and that higher prices can result. Thus, bank holding company entry into the securities markets promise to benefit customers seeking securities services by lowering prices. (For background on the highly concentrated securities industry, see pp. 30 and ff. in "Rethinking Glass-Steagall," a publication of J. P. Morgan & Co. Inc. dated December 1984.)

Also, the above-referenced publication notes (p. 20) that the after-tax annual rate of return on equity for investment banking firms is roughly twice that of the ten largest bank holding companies, indicating that substantial profits accrue to these firms. Additional competition would have a downward effect on prices, and would have a probable downward effect on the return on equity in the securities firms. Hence strong opposition from the securities industry to bank holding company entry is understandable.

Q. Those who oppose the affiliation of banks and securities firms maintain that conflicts of interest resulting from such affiliations justify the preservation of the Glass-Steagall Act. Banks have long faced potential conflicts of interest, particularly between their commercial lending and trust activities. Securities firms face comparable potential conflicts in their various roles as underwriter, broker, dealer, and investment adviser. Do you believe divorcing the two, because of potential conflicts, imposes unnecessary costs on society?

Answer. As with all such questions, there is a need to weigh the concern about unfair or unsound conflicts-of-interest activities on the one hand against what should be just as great concern for the efficiency and competitiveness of markets. It is important to recognize that commercial banks for years have dealt with the prospect of potential conflicts of interest emerging from the commercial lending and trust functions being conducted under the same roof. No adverse consequences have occurred from these operations, and the potential conflicts have been handled by regulations. We believe that, using the framework of separate subsidiaries established by the Administration's proposal, potential conflicts of interest that might arise from the additional activities authorized in the bill can be dealt with through adequate disclosure and regulation. As I indicated in my answer to your first question, there appear to be real costs associated with securities activities now being carried out by a relatively few firms in a highly concentrated market. These costs can be reduced by the appearance of new entrants; the potential for conflicts of interest should not be used as an excuse to prevent such additional competition from coming into being.

Q. In recent months, there has been a growing number of bank failures throughout the nation. In some states, entire bank systems have come under suspicion. It seems that each time a small bank faces financial trouble, a large out-of-state bank moves in. When an entire system fails, as was the case in Ohio, large interstate banks move in to straighten out the situation. For all practical purposes, interstate banking is proceeding, despite the lack of congressional action on the subject. I am hoping that as financial experts you could provide additional insight into this matter. Do you believe consumers will benefit? Will interstate banking provide safer banking?

Answer. The Association of Bank Holding Companies is very concerned about the way interstate banking is proceeding -- i.e., on a piecemeal, random basis. On the one hand, non-banking financial firms such as Sears and Merrill Lynch are marketing bank-type products nationwide. On the other, some states (about 25) have taken some sort of initiatives providing for interstate banking on a regional or national basis. Many other states are looking at the possibility of such legislation. What it all adds up to at the moment is a chaotic spate of activity. Congress needs to step in and impose a federal framework, including an appropriate transition period, leading to a national banking system at a date certain. The bill reported by the House Banking Committee, although flawed, provides for this fundamental improvement.

The Association strongly supports S. 1098, sponsored by Senator Cranston, as a reasonable approach toward nationwide banking. Because S. 1098 (and H.R. 2707) deal exclusively with bank holding company acquisitions, they meet the test of providing a national system that is safe and sound. By utilizing the safeguards of regulation and supervision built into the Bank Holding Company Act, Congress can assure American consumers that the financial institutions they are dealing with operate on a safe and sound basis. Since the Act is the only federal banking statute that combines in one place a complete system of regulatory and supervisory controls that permit fair competition and safe and sound operations, and a healthy banking system requires geographic diversification (as the recent farm loan and oil and gas lending problems have indicated) the extension of banking services nationwide can be accomplished by pursuing the approach in S. 1098.

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MORGAN B. STARK, President, Dealer Bank Association

RESPONSE OF THE DEALER BANK ASSOCIATION TO QUESTIONS FROM SENATOR GARN

QUESTION. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Why?

ANSWER. Because the Association is most familiar with the relationship between banking and securities activities, we will limit our response to that part of the question. On that topic, we believe that the marketplace has largely erased the traditional lines between banking and securities activities over the last ten years, and that further deterioration of those lines is inevitable. We believe that this is a healthy competitive development, and that all users of financial services (including corporate and governmental issuers and borrowers, and individual investors and depositors) will be well served by the continued blurring of outdated lines, if the Congress acts promptly to establish a legal structure that permits competition to flourish under appropriate regulatory requirements.

As the record before this Committee demonstrates, banking institutions are active and important participants in the domestic and international capital markets in many ways in addition to underwriting and dealing in eligible securities. The increasing participation of banking organizations in the capital markets is driven by changes in technology, customer demand, and sophisticated business needs, as well by legal and other developments that have required banking organizations to pay increased attention to both sides of their balance sheets.

Thus, for example, the funding process is no longer solely a process of gathering core deposits at regulated interest rates. Investors and depositors have a large number of alternatives readily available to them. Large banks in particular are heavily dependent upon the distribution of negotiable CD's in the domestic and Eurodollar markets. Those markets are broad and deep and the competition for funds is strong.

The blurring of lines between historic securities activities and banking activities is also proceeding on the asset side of the balance sheets of banks of all sizes. For example, banks sell and purchase participations in commercial loans to and from each other, and other institutional investors, in a manner which bears many similarities to the sale and purchase of corporate bonds. It is not that banks have moved

into the securities business, but that the business of banking and the business of being an underwriter and dealer in the public securities markets are growing together.

The growing identity of the banking and securities markets themselves can also be assessed from the point of view of borrowers. The very best corporate credits already have access to the public securities markets without the intermediation of the banking system. A corporate financial officer naturally seeks the best financing alternatives among bank, public market, or private placement financing. For borrowers who have access to the public markets, that alternative will often be less expensive and involve fewer restrictions than bank financing.

There is substantial evidence of this development. The commercial paper market reached $250.6 billion outstanding in March 1985, exceeding the $246.2 billion in commercial and industrial loans by commercial banks. For borrowers with assets of $1 billion or more, commercial paper issuance has largely displaced bank borrowing. For example, the share of commercial bank loans among the short-term liabilities of corporations with assets in excess of $1 billion declined from 56% in 1973 to 17% in 1983. In contrast, the share of commercial paper rose from 33% to 40% during the same period.

Moreover, we are fast approaching the day when, in practical effect, there will be one large international capital market. Financial institutions unable to operate fully in all aspects of the domestic and international capital markets will not be able to price or distribute new issues as efficiently as firms that can do so. Of course, subsidiaries of U.S. bank holding companies can underwrite corporate securities in the Euromarket and do so extensively. But the Euromarket is only part of the worldwide securities market, and U.S. bank holding companies cannot serve the full range of the financing needs of their U.S. customers in the United States. The result is totally irrational: U.S. banks and bank holding companies may originate and syndicate loans in the United States and abroad; they may provide a full range of underwriting and related services abroad, but may not do so in the United States.

The results of this crazy-quilt pattern are not consistent with the goals of a sound and competitive banking system. First, if the existing rules are not altered, the range and quality of the financial services provided to customers by banking organizations will necessarily decrease. The borrower or issuer makes a single financing decision among its economic alternatives -- a decision that has nothing to do with the differentiation between bank financing and the capital markets (and between domestic and foreign markets) that is reflected in

much of our existing legal structure. This is more than merely a matter of competitive equity -- it is a matter of banks being in a position to provide a full range of financial alternatives instead of offering only part of an array of financing options.

Second, the ability of borrowers to shift from one market to another generates significant market pressures on the pricing of banking services to corporate customers. The pricing of loans is becoming increasingly similar to the pricing of securities. Loans are increasingly priced on the basis of a spread over a market rate of interest in a manner similar to the pricing of new issues of corporate securities at a spread over Treasury securities of equivalent maturity. Although banks may be able to shift some of the credit and interest rate exposure to other banks through participations, securities underwriters shift those risks in their entirety to investors.

Third, the gravitation of higher quality corporate borrowers away from the banking system and directly to the public capital markets, combined with the inability of banking organizations to provide underwriting services to those borrowers will in the long run increase risk in the banking system. That will occur because of the overall decrease in the quality of bank loan portfolios and the inability of bank

holding companies to diversify their income streams through expanded securities activities. On the other hand, allowing banking organizations to underwrite and deal in securities would lower overall risk, and provide a stream of income from activities that are replacing direct lending. Improving the quality and stability of the earnings of bank holding companies in this way should reduce the cost of capital for banking institutions, and would allow full and efficient use of existing human, technological and financial resources and skills that have been developed by banking organizations in response to evolving market forces.

QUESTION. Should Congress authorize joint ventures among and between participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

ANSWER. Banking and securities firms are already permitted to engage in a limited set of joint venture activities and activities that, while not strictly joint ventures, have cooperative aspects. Ordinarily the approval of the Federal Reserve Board or another federal bank regulator is required before these joint venture or cooperative activities are commenced.

We think that Congress should confront directly the question of what sort of banking activities securities firms should be allowed to engage in, and what sort of securities activities banking firms should be allowed to engage in -- and in both situations, under what sort of regulatory procedures and requirements. Once that decision is made, securities and banking firms would be free, subject to regulatory approval and examination, to engage in joint ventures in permissible activities if that was an economically desirable way to conduct the activity, as in many cases it might be. However, authorization of joint ventures is not a substitute for authorization of appropriate securities and banking activities by diversified financial institutions.

QUESTION. Many analysts claim that commercial and personal loans are in the process of being "securitized". They point to commercial paper, mortgage backed securities, auto loans, and junk bonds. Do you agree?

ANSWER. It is true that many loans are being "securitized", and that securitization holds out many benefits for borrowers and lenders alike.

Securitization is not a wholly new process, of course. Mortgage loans have been securitized by federal agencies and corporations for many years, with great success. Banks underwrite and deal in these mortgage-related securities in huge volumes, bringing liquidity to both the mortgage-related securities marketplace and to the balance sheets of mortgage originators. Allowing banking organizations to compete in the private mortgage-related securities marketplace, which is predicted to grow enormously over the next decade, will likewise make these markets more competitive, provide a source of fee-based income for banking organizations, and increase the liquidity of loan originators (including banks).

Commercial paper is not a form of securitized loan. Rather, commercial paper is a direct obligation of a highly credit-worthy corporation, typically sold in very large denominations to institutional and other sophisticated investors. Thus commercial paper is a substitute for a bank loan, not a security backed by a pool of loans made by a bank or other financial institution. The ability of high-quality issuers to tap directly into the capital market for short-term funds at rates below those available from banks demonstrates both the efficiency of using securities instead of bank loans in many instances, and the need for banking organizations to have the

legal authority to serve their customer's financing needs in more varied ways.

"Junk bonds" are not securitized loans. They are unrated, high-yielding corporate debt, often used in connection with takeover attempts.

QUESTION. Commercial banks in London, including affiliates of U.S. banks, can engage in a broader range of investment banking activities than commercial banks in the United States. (a) Are you aware of serious safety and soundness problems that have arisen from these activities in London? Conflict problems? Why or why not? (b) Does a financial institution operating in London have a competitive advantage over one operating in the U.S.? If so, have banks in the U.S. lost business to English affiliates or competitors?

ANSWER. (a) We are not aware of any serious safety and soundness problems, or conflict of interest problems, that have arisen on account of the securities activities of affiliates of United States banks in London. Those securities activities include, as the Committee is aware, underwriting and dealing in corporate securities, including the securities of U.S. corporations. There are no serious safety and soundness

or conflict of interest problems arising from the underwriting and dealing activities of bank affiliates in London because U.S. bank holding companies are fully capable of conducting those activities safely and professionally, without risk or conflict problems, even in an environment that has much less regulatory oversight than would be true in the United States. In our view, the experience in London confirms that there is no safety and soundness, or conflict of interest, reason to prohibit U.S. banking organizations from underwriting and dealing in securities in the United States. The London experience also confirms that allowing banking organizations to compete fully in the capital market will bring lower costs and product innovations to issuers and buyers of securities. Indeed, the U.S. Treasury has recently issued debt securities in the Euromarket to reap these benefits.

(b) Under some circumstances a financial institution operating in London will have a competitive advantage over one operating in the U.S. The competitive advantage is greatest for the broker/dealers who can underwrite and deal in securities both in the United States and abroad. They have an advantage in every public corporate underwriting in which the issuer has a choice of locations: by using a broker/dealer, the corporate issuer can have its securities sold in the United States

or abroad, while by using an affiliate of a U.S. bank, it can sell the securites only abroad. The way to eliminate these competitive advantages is to permit U.S. financial institutions to underwrite and deal in securities in the U.S., just as they are permitted to do in the Euromarket.

QUESTION. It has been reported that foreign banks now (originate) more than 40% of the commercial loans to U.S. domestic corporations in the New York market. Is this true? If so, why?

ANSWER. Based on the views of various experienced individuals, but without conducting an extensive analysis, the Association believes that it is quite possible that foreign banks account for as much as 40% of the commercial loans made to U.S. domestic corporations in the New York market. We are inclined to doubt that foreign banks actually originate that high a percentage of such loans, but they can acquire such loans through syndication or loan participations or sales. As we have noted above, the use of syndicates or loan participations is one of the ways in which the lending markets and the securities markets are merging. For a variety of reasons (particularly, we believe, capital requirements and leverage), foreign banks are better suited to hold loans on their balance

sheets than domestic banks; but domestic banks may be better situated to originate loans.

QUESTION. In his testimony James McCormick, Presidentof First Manhattan Consulting, indicated that capital and reserve requirements coupled with having to pay market rates on deposits is beginning to make the traditional bank profit formula obsolete. Do you agree? Why or why not?

ANSWER. We believe that Mr. McCormick's testimony makes a powerful case for allowing banking organizations to serve the needs of their customers in more varied ways, including particularly thorough the use of securities to meet financing needs rather than just loans. We think it clear that the "traditional bank formula" -- making loans to quality credits through the use of interest-rate controlled deposits -- is becoming outdated, in part because of capital and reserve requirements, but even more fundamentally because of changes in the legal environment (such as the deregulation of deposit interest rates), in technology, and in the marketplace. These matters are discussed in more detail in our answer to Question No. 1.

QUESTION. Why should bank and thrift holding

companies be given the authority to underwrite and distribute mortgage backed securities, particularly in light of Bank of America's problem in this area?

ANSWER. Bank holding company subsidiaries should be given the authority to underwrite and deal in mortgage-related securities because (a) they have the human, financial and technological expertise to do so, growing out of the securities activities in which they already engage in a safe and sound manner, including particularly underwriting and dealing in mortgage-related securities issued by various federal agencies and corporations; and (b) the market for underwriting and dealing in private mortgage-related securities is extremely concentrated (indeed, it is dominated by just two broker/dealers), and the additional competition from bank holding company subsidiaries will aid homebuyers and homebuilders, mortgage-originators, and the buyers of securities based on mortgages.

We think that last year's Senate Committee Report put the point very well indeed:

> Encouraging the provision of capital to finance the housing needs of this country has always been a matter of significant Congressional concern and interest. Recent estimates by the Federal National Mortgage Association ("FNMA") suggest that $1.6 trillion or more will be needed to finance home mortgages between now and 1990. Much of this amount (approximately

one-half according to FNMA) will be financed through the origination of mortgages and their resale into the secondary market. The purchase of a single mortgage by an investor may be unattractive, however, because of the risk of repayment prior to the stated maturity date. The pooling of many individual mortgages and the sale of participations in those pools enhances the attractiveness of such purchases to investors because the pool's diversification spreads the risk and provides greater actuarial consistency of payment and repayment.

Depository institutions, both thrift organizations and banks, and their holding company affiliates have long been active participants in providing for the country's housing needs. Depository institutions originate mortgage loans directly either for their own portfolio or for eventual resale to an institutional investor.

But depository institutions actively provide real estate financing in other ways as well. When it was enacted, the Glass-Steagall Act expressly reserved the power of national banks to sell obligations evidencing loans on real estate. 12 U.S.C. 378(a)(1). The Glass-Steagall Act also expressly permits banks to underwrite deal in, or purchase for their own account obligations issued by FNMA, the Government National Mortgage Association, or the Federal Home Loan Mortgage Corporation -- all government-related agencies which issue securities based on pools of residential mortgages. In addition, as noted above, banks are specifically permitted to deal in and underwrite non-general obligations issued by a State or local governmental unit for housing purposes. The provision of the bill authorizing DISA's to underwrite or purchase and sell mortgage backed securities merely clarifies that these affiliates of depository institutions can continue to occupy an integral role in this evolving method of real estate financing.

The reported losses of the Bank of America have no connection whatsoever to its role as an underwriter and dealer in mortgage-related securities. The loss did not come from underwriting and dealing in such securities, but rather, it appears, from acting as an escrow agent. The role of an escrow agent is very different, of course, from the role of

underwriter or dealer. According to press reports, Bank of America's losses arose because two convicted felons caused Bank employees to act as escrow agents for mortgage-loan participations based on grossly inflated appraisals. Press reports also say that the Bank fired seven officers and employees and is seeking to recover under its directors' and officers' liability insurance. Fraud and dishonesty are not forgivable, but they are, unfortunately, a fact of life in almost every industry at one time or another. Bank of America's problem provides no more reason for barring banking organizations from underwriting and dealing in mortgage-related securities than E.F. Hutton's problems provides a reason for keeping broker/dealers out of the mortgage related securities business.

QUESTION. The legislation which passed the Senate last fall provided for a very modest expansion in the range of services that banks could offer their customers, but it was a step in the right direction. If banks are not authorized to broaden the services which they can offer: a. What will be the impact on bank's ability to maintain expensive brick and morter facilities for the convenience of consumers? b. What will be the impact on the ability of the industry to raise capital and what will be the impact on the riskiness of the industry?

ANSWER. We believe that if banking organizations are not permitted to broaden the range of services they offer, even to the modest extent reflected in last year's Senate Bill, their ability to continue to maintain facilities for customer convenience will be diminished. Failure to allow banking organizations to diversify their activities and to engage in a wider array of fee-generating services, like the securities activities in last year's Senate Bill, will also make it increasingly difficult for banking organizations to satisfy the return-on-assets and return-on-equity requirements of the marketplace, and therefore to raise necessary equity and debt capital.

There is no question that restricting the activities in which banking organizations can engage will make the banking business riskier. For example, if banking institutions cannot serve their most credit worthy corporate clients by providing a full range of securities services, they will have to look deeper and deeper into the group of less creditworthy corporate customers for clients to whom to make loans. Similarly, if banking organizations are not permitted to compete in the mortgage-related securities market, that market will remain concentrated and mortgage originators (including banks and thrifts) will not be able to realize the best price for their

mortgages and the maximum liquidity for their assets. The result will be that home-buyers will not realize the lowest possible interest rate on their home mortgages.

QUESTION. Your statement supports the securities provisions contained in S.2851, which passed the Senate last year; but it also argues for repeal of the Glass-Steagall Act. Are you asking the Committee to go beyond the framework of S.2851 at this time?

ANSWER. We ask the Committee, and the Congress, to pass legislation, as soon as possible, that permits banking organizations to compete in the municipal revenue bond, commercial paper, mortgage-related securities, and mutual funds portions of the capital market. These activities have been the subject of numerous congressional hearings, and extensive governmental and private study. We believe that the Committee and the Congress can and should move quickly in this regard, because the record proves that the securities activities covered by S. 2181 (and mutual fund authority) constitute a natural and logical extension of services that banks have been providing for fifty years, and present no fundamental Glass-Steagall issues.

We also believe that the Committee and the Congress should begin consideration, as soon as the schedule permits, of the question whether the Glass-Steagall Act represents sound and sensible public policy under modern regulatory and market conditions. We recognize that congressional consideration of this question will not involve legislation at this time, but we think that the Committee should begin the process of debate, study, and analysis of the benefits -- in terms of economic growth and job creation, as well as the increased stability and soundness of the banking system -- that can be achieved by a fundamental revision of Glass-Steagall.

QUESTION. Are you contending that Glass-Steagall no longer serves a useful public purpose?

ANSWER. Yes. Indeed, we think that Glass-Steagall not only no longer serves a useful purpose (if it ever did), but also that Glass-Steagall is counter-productive in that it prevents banking organizations from providing much-needed competition in the nation's capital market. The reasons for our conclusion are set forth in some detail in Mr. Stark's written testimony, which demonstrates (a) that banking organizations are active, safe and viable competitors in many portions of the capital market today (including securities issued abroad by

U.S. corporations); (b) that Glass-Steagall is unnecessarily anti-competitive; (c) that the safety and soundness of the banking system would be enhanced, not diminished, if banking organizations were permitted to engage in a full range of securities activities; (d) that our modern regulatory system, together with the discipline of today's highly competitive marketplace, provide more than adequate assurance against any theoretical conflict of interest becoming an actual abuse; and (e) that fundamental reform of Glass-Steagall is necessary to maintain banking institutions as effective financial intermediaries. As Mr. Stark made clear, the Association believes that reform of Glass-Steagall is "very much a two-way street" -- that is, securities firms should be able to own full-service banks just as banking organizations should be permitted to own full-service securities firms. We believe that all the customers of these institutions -- corporate, public body and individual borrowers, as well as institutional and individual investors and consumers -- would be well-served by the additional competition.

QUESTION. The securities industry argues that the requirement of a separately-capitalized subsidiary for the conduct of securities activities will not provide an adequate protection for the bank or other depository institutions should

the securities affiliate get in trouble. They cite the statement of Walter Wriston to the effect that no holding company can afford to walk away from the problems of its corporate subsidiaries. What are your views on this issue?

ANSWER. Mr. Wriston did not say, and it is not true, that the separately-capitalized subsidiary requirement for the conduct of securities activities would be inadequate to provide protection for the bank (or other depository institution) if the securities affiliate started to falter. In fact, all that Mr. Wriston did say is that management of the holding company, and the holding company itself, would not simply walk away from customers and clients of the securities subsidiary if there were difficulties. One would not expect management of any institution to take any different position.

In considering this issue, one must first note that the liklihood that the securities subsidiary will falter at all, much less in a serious way, is very small. Banks and their affiliates are engaged in many underwriting and dealing activities, including underwriting and dealing in corporate securities abroad, and there is no evidence of any substantial losses from such activities. There is no reason to think that this record of safety, soundness and competence would suddenly

change. To the contrary, as banking institutions have become more and more active in the securities markets, as has occured over the past 15 years, they have developed expertise in managing the risks that are involved in those activities. Indeed, experience teaches that underwriting securities is less risky than making and holding loans on the bank's balance sheet.

Moreover, given the attention of management and analysts and regulators to the return-on-equity and return-on-assets earned by banking institutions, it is unlikely that a securities affiliate would actually ever reach a stage of terminal distress. It is much more likely that the securities affiliate would be sold by the parent bank holding company or its operations discontinued or reduced, long before any safety and soundness problem becomes a threat to the holding company as a whole.

Finally, whatever management's view may be, the bank regulators can and will take steps to prevent the securities affiliate from posing any serious threat to the bank. Not only are there prohibitions on using the bank's deposits either directly or indirectly to finance the activities of the securities affiliate, but the regulators can prevent unsafe and unsound practices in various ways, and can even take control of

the bank if necessary. Of course, no such drastic action has been necessary on account of securities activities in which banks now engage, and no such drastic action is ever likely to be necessary on account of an expansion of those activities.

MORGAN B. STARK, President, Dealer Bank Association

RESPONSE OF THE DEALER BANK ASSOCIATION TO QUESTIONS FROM SENATOR D'AMATO

QUESTION. The Glass-Steagall Act was viewed by its proponents as an integral part of the effort to restore public confidence in the banking system after its collapse in 1933 and to protect depositors by insuring the stability of commercial banks. In particular, the Act's substantial separation of commercial and investment banking was designed to eliminate the problems and abuses Congress believed were associated with commercial banks' securities activities. Do you believe the Act was too sweeping and that the problems it was meant to solve could be addressed with other legislation? Would this enhance the banking industry? Would the consumer benefit?

ANSWER. We believe that the Glass-Steagall Act is unnecessarily sweeping, and that fundamental reform of the Act would be beneficial both to the banking and securities industries and to all consumers of financial services.

Glass-Steagall is overly broad insofar as it prohibits banks and their affiliates from engaging in certain

securities activities, rather than regulating the conduct of those activities so that banking organizations can compete in the marketplace under a set of rules that fully protects the public interest. For example, under our modern regulatory and legal structure, it is not necessary to prohibit bank affiliates from underwriting securities in order to protect trust accounts of the bank, because applicable laws and regulations, enforced by federal regulators, prohibit any "dumping" of securities into trust accounts. Similarly, it is not necessary to prohibit bank affiliates from underwriting securities in order to protect customers of the affiliate from buying securities the proceeds of which will be used to liquidate a bank loan; the securities laws would today require disclosure of a material fact of this sort to the prospective buyer. In short, allowing banking organizations to compete under appropriate regulation is far preferable as a matter of public policy than is the overbroad prohibition contained in Glass-Steagall as it now stands.

The banking industry would benefit from fundamental reform of Glass-Steagall because it would allow banking organizations to diversify their sources of income, and to serve their customer needs in a variety of ways, instead of being limited to making loans. This is increasingly important

as the banking and securities markets continue to blend into one another. Indeed, as explained in Mr. Stark's written testimony (pp. 24 et seq.), it is essential to revise Glass-Steagall in order to maintain banking institutions as effective financial intermediaries in our evolving capital market.

Finally, and perhaps most importantly, we think that reform of Glass-Steagall would clearly benefit consumers of financial services. Issuers of securities -- including not just large corporations, but also small businesses, originators of mortgages or consumer receivables, and state and local governments -- would benefit from increased competition and professional competence in underwriting and dealing that bank holding company securities subsidiaries would bring. Consumers would benefit both insofar as they are investors (where the additional competition will produce tighter pricing and better services) and insofar as they are homebuyers and buyers of durable goods bought on credit (in both cases the ability of their lenders to sell securities based on home and consumer loans would keep interest costs down).

Moreover, the overly broad sweep of the Glass-Steagall Act creates inexplicable inconsistencies in the marketplace. As noted in response to Senator Garn's first

question, commercial paper and syndicated bank loans perform the similar functions for coporate borrowers (a function similar to that of some CDs for depository institutions), and yet banks are limited in their activities with respect to commercial paper. This inconsistency is also evident in the type of municipal obligations that banks can deal in and underwrite: for example, as Mr. Stark pointed out in his oral testimony, it makes no sense that banks can underwrite revenue bonds issued by the Washington Area Metropolitan Transit Commission, but that they cannot underwrite a roughly one billion dollar issue of water revenue bonds needed by New York City.

QUESTION. Those who oppose the affiliation of banks and securities firms maintain that conflicts of interest resulting from such affiliations justify the preservation of the Glass-Steagall Act. Banks have long faced potential conflicts of interest, particularly between their commercial lending and trust activities. Securities firms face comparable potential conflicts in their various roles as underwriter, broker, dealer, and investment adviser. Do you believe that divorcing the two, because of potential conflicts, imposes unnecessary costs on society?

ANSWER. Yes. As stated in Mr. Stark's testimony

(pp. 19 et seq.), all diversified financial institutions have theoretical conflicts of interest growing out of their multiple roles. Securities firms serve not only as brokers and dealers, but also as investment advisors, underwriters, and, through their affiliates, as commercial lenders; in addition, they hold credit balances from their customers and, through their "nonbank banks" offer federally insured deposit instruments. Bank holding companies, through their bank and nonbank subsidiaries, also provide a range of services that raise theoretical conflicts.

There is no evidence of any pattern of actual conflict of interest abuse in either the banking or the securities industry -- that is, these theoretical conflicts are not, it turns out, real problems in the real world. There are two fundamental reasons why the theoretical problems are not real ones. First, the modern regulatory and legal structure, including particularly the disclosure requirements of the securities laws and the examination procedures of the banking and securities laws, provide assurance that the many laws prohibiting actions that involve conflicts of interest are enforced. Second, the discipline of the marketplace is real and unforgiving: any institution that abused its relationship with its customers or clients or correspondents would soon find

its business lost to its competitors (as has recently happened to E.F. Hutton).

Thus, to the extent the prohibition on affiliations between securities firms and banks is designed to prevent potential conflicts of interest from arising, it is unnecessary, because regulation and market discipline are effective at preventing conflict of interest abuse. Yet the economy pays a high price for the prohibition -- an unnecessarily high price -- because the prohibition has kept banking organizations from entering highly concentrated markets, even though they are the organizations best situated to compete and most likely to do so absent the artificial barrier of Glass-Steagall.

QUESTION. In recent months there has been a growing number of bank failures throughout the nation. In some states entire bank systems have come under suspicion. It seems each time a small bank faces financial trouble, a large out of state bank moves in. When an entire system fails, as was the case in Ohio, large interstate banks move in to straighten out the situation. For all practical purposes, interstate banking is proceeding, despite the lack of congressional action on the subject. I am hoping that as financial experts you could provide

additional insight into this matter. Do you believe consumers will benefit? Will interstate banking provide safer banking?

ANSWER. The Association has taken no position regarding interstate banking, and we therefore leave the answer to this question to other trade associations representing the banking industry.

MORGAN B. STARK, President, Dealer Bank Association

RESPONSE OF THE DEALER BANK ASSOCIATION TO QUESTION FROM SENATOR PROXMIRE

QUESTION. Those who are opposed to bank holding companies underwriting mortgage backed securities point to the recent debacle at Bank of America where the bank took substantial losses on these securities when it was merely acting as a fiscal agent. They say "think what could happen if banks were allowed to underwrite -- the losses could be even greater." How do you respond to these arguments that underwriting mortgage backed securities it soo risky for banks or bank holding companies?

ANSWER. It is simply not true that underwriting and dealing in mortgage-related securities is "too risky" for bank holding company subsidiaries.

In the first place, banks themselves are today actively engaged in underwriting and dealing in mortgage-related securities issued by GNMA, FNMA and FHLMC. While all three are government-related, Fannie Mae is a privately owned for-profit corporation. Banks underwrite and deal

in Freddie Mae, Fannie Mae and Ginnie Mae securities with no undue risk or history of loss. The same will be true of other mortgage-related securities.

The risk in underwriting and dealing in mortgage-related securities is principally a market risk -- the risk of mispricing -- and not a credit risk. The risk banks take today in underwriting mortgage-related securities is exactly the same risk involved in underwriting the additional mortgage-related securities covered by S. 2181.

We understand that the Securities Industry Association referred to the risk of accumulating mortgages before they are "securitized" as a reason not to permit banking organizations to compete fully in the mortgage-related securities market, which is now dominated by two SIA members. If our understanding of the SIA assertion is correct, the SIA has brought a whole new meaning to the word "disingenuous." There is a risk involved in holding mortgage loans on your balance sheet, to be sure. But that is a risk that banks take every day and in huge quantities. And even more to the point, it is that very risk -- the risk of holding mortgage loans as principal -- that banks could limit by being allowed to underwrite and deal in mortgage-related securities!

As to the Bank of America situation, the loss the question refers to had no connection whatsoever with the Bank's role as an underwriter and dealer in mortgage-related securities. The loss, it appears, arose out of the Bank's role as escrow agent, a very different role from that of underwriter or dealer. According to press reports, Bank of America's loss came about because two convicted felons caused Bank employees to act as escrow agent for mortgage-loan participations based on grossly inflated appraisals. Press reports also say that the Bank fired seven officers and employees, and is seeking to recover under its directors' and officers' liability insurance. Fraud and dishonesty are not forgivable, but they are, unfortunately, a fact of life in almost every industry at one time or another. Bank of America's problem provides no more reason for barring banking organziations from underwriting and dealing in mortgage-related securities than E.F. Hutton's problem provides a reason from barring all securities firms from that business.

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JAMES G. CAIRNS, JR., President, Peoples National Bank of Washington, Seattle, WA; President, American Bankers Association

Questions from Senator Garn - June 19, 1985

1. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Why?

The continued blurring of the lines between banking, insurance, and securities is inevitable because of a broad set of changes affecting the financial services industry. These changes include, among other things, the rising affluence of the U.S. economy, the behavior of interest rates, the advances in technology, the effects of innovation and innovators, and the diverse workings of regulation itself, especially inequities resulting from different rules for competing financial entities.

As I testified, even if the nonbank-bank loophole is closed, conglomerates would still be able to offer deposit services to their customers by providing a deposit substitute such as a money market fund or a cash management type account from which third-party transfers can be made, and by selling the deposits of banks or thrifts to their customers as a deposit broker. In addition, they would still be able to offer the same consumer, real estate, and commercial loans as banks while they are providing their primary activities, which in some cases include all the securities, insurance, and real estate powers outlined in our consensus position.

Our Association believes that the appropriate response to this continuing competitive imbalance would be for Congress to give all financial institutions the authority to offer the full range of financial services that their customers demand. To preserve banking's ability to serve the needs of its customers and compete in the current environment, our Association believes that legislation to expand the permissible activities of bank holding companies must include the sponsorship and sale of mutual funds; the underwriting of municipal revenue bonds, mortgage-backed securities and commercial paper; insurance underwriting and brokerage; and real estate equity investments, joint ventures, development and brokerage. Also, it must close the nonbank-bank loophole and authorize geographic expansion within the spirit of states' rights.

2. Should Congress authorize joint ventures among and between participants in the banking, insurance, and securities industry? If so, what types of joint ventures should be permitted?

Inasmuch as the ABA is already on record as supporting legislation to permit the banking industry to enter into insurance and securities activities, it is only natural and complementary that we would also support permitting banks to establish joint ventures in these areas. Joint venture arrangements offer an excellent means by which banks can test consumer acceptance of comprehensive financial services offerings, and by which all segments of the financial services industry can offer a wider array of products and services without excessive training or marketing costs. Joint venture arrangements would appear particularly attractive for smaller banks, insurance, and securities firms.

The opportunities for such cooperative arrangements should include the joint establishment of fully separate organizations; as well as arrangements of lessor scope such as joint marketing agreements, profit sharing arrangements, and percentage leases for activities conducted on bank property. While the ABA is on record in support of the requirement that insurance and securities activities entered into directly by banking organizations be conducted in a separate subsidiary, lesser degrees of

separation would appear to be justifiable as a bank's involvement in a joint arrangement diminishes. An excellent example of this principle is that the OCC already permits banks to offer percentage leases to insurance agents operating on bank property; in this case, the bank exercises no control over the conduct of the activity and the risk to the bank is negligible.

3. Many analysts claim that commercial and personal loans are in the process of being "securitized." They point to commercial paper, mortgage-backed securities, auto loans, and junk bonds. Do you agree?

We agree completely. The nation's top commercial firms, who formerly constituted the commercial banking industry's top quality loan customers, now raise the vast majority of their short-term funds in the commercial paper market. In fact, there is now slightly more commercial paper outstanding than there are commercial loans and industrial loans made by commercial banks. The next lower tier of corporate America is now following a similar pattern through the issuance of "junk bonds." As for mortgage-backed securities, approximately thirty percent of all residential mortgages are currently being securitized and there is every reason to believe that this percentage will increase year after year. And increasingly, other debt instruments, such as automobile loans and consumers receivables, are being packaged into securities for resale in the secondary market. Finally, money market mutual funds remain an attractive functional equivalent to transactions accounts for many individuals.

Market dynamics would seem to dictate that the securitization process will continue and perhaps even accelerate. For borrowers, securitization generally offers a lower cost of raising funds than traditional debt finance because it permits more efficient use of capital through greater leverage. For financial institutions, securitization offers a means of increasing liquidity and reducing interest rate risk. Finally, an ever growing percentage of the nation's capital is under the control of institutional investors such as pension funds who prefer to invest in securities portfolios, rather than to deposit their funds in traditional bank deposit instruments.

4. Commercial banks in London, including affiliates of U.S. banks, can engage in a broader range of investment banking activities than commercial banks in the U.S.

a. Are you aware of serious safety and soundness problems that have arisen from these activities in London? Conflict problems? Why or why not?

b. Does a financial institution operating in London have a competitive advantage over one operating in the U.S.? If so, have banks in the U.S. lost business to English affiliates or competitors?

We are presently investigating, through discussions with multinational bank participants, the conduct of investment banking activities by U.S. banks in London. Rather than delay our response to your other questions, we will forward our reply to this inquiry as soon as we complete our review of this matter.

5. It has been reported that foreign banks now originate more than 40% of the commercial loans to U.S. domestic corporations in the New York market. Is this true? If so, why?

According to the Division of International Finance of the Federal Reserve Board, at the end of 1983, the agencies, branches and commercial bank subsidiaries of foreign banks held approximately 40 percent of the commercial loans outstanding in the New York market to both U.S. domestic and foreign corporations.

The rapid growth of foreign banks in the U.S. began during the 1970s. In the mid-70s, a number of possible competitive advantages that may have contributed to that growth were identified in congressional hearings leading to the International Banking Act of 1978. They included: the lower capital requirements of foreign banks; and the absence of reserve requirements and deposit insurance for foreign branches. The International Banking Act specifically aimed at eliminating some of those advantages.

A significant factor in the growth of foreign banks was their agressive price competition. However, the American Banker's annual survey of foreign institutions' activities in U.S. banking (February 21, 1985) revealed that business loans rose a "modest" 9.4 percent for foreign banks' U.S. offices between June 30, 1983 and June 30, 1984, partly because the price differentials that existed between American banks and foreign banks in the U.S. marketplace have been eliminated.

6. In his testimony James McCormick, President of First Manhattan Consulting, indicated that capital and reserve requirements coupled with having to pay market rates on deposits is beginning to make the traditional bank profit formula obsolete. Do you agree? Why or why not?

As we indicated in our response to question #3, the "securitization" of traditional debt instruments is already widespread, and can be expected to continue and expand.

While we do not concur entirely with all of Mr. McCormick's views, we are in general agreement that market dynamics and efficiency realities are reducing the profitability of traditional lending activities. The proper public policy response is to permit banks to continue to meet the financial needs of their customers by expanding the range of permissible bank products and services activities. There is no reason why banks should be constrained from remaining fully competitive; nor is there any reason to deny consumers and businesses the benefits of competition.

Mr. McCormick's views would also indicate that any contemplated increase in bank capital requirements should be reviewed very carefully prior to implementation. By further reducing bank leverage, higher capital requirements could render banks less competitive and thereby have the ironic effect of reducing, not enhancing, their safety and soundness.

7. Why should bank and thrift holding companies be given the authority to underwrite and distribute mortgage-backed securities, particularly in light of Bank of America's problem in this area?

Banks and thrifts are already permitted to originate mortgages and to buy mortgage-backed securities for their own portfolios. Therefore, it seems both incongruous and inefficient to require them to turn to third parties to package these mortgages into saleable securities. Permitting banks and thrifts to underwrite mortgage-backed securities would entail no additional risk to these institutions, inasmuch as the only consequence of a failure to fully market a securities offering would be that the intermediary would retain the securities within its own portfolio -- exactly the situation which existed prior to the creation of the securities when the bank held the mortgages. Authorizing this new power should, in fact, enhance the safety and soundness of depository institutions by increasing their liquidity and reducing their interest rate risk. Finally, there should be significant public benefits of authorizing this power, as the reduction in underwriting costs resulting from greater competition, in combination with the enhanced liquidity of the market, would serve to attract increased investments in housing finance by institutional players.

As for Bank of America's problem, it is our understanding that the Bank was defrauded while acting as escrow agent and trustee; and that the opportunity for this fraud would not have existed had the Bank been able to underwrite such securities.

8. The legislation which passed the Senate last fall provided for a very modest expansion in the range of services that banks could offer their customers, but it was a step in the right direction. If banks are not authorized to broaden the services which they can offer:

a. What will be the impact on banks' ability to maintain expensive brick and mortar facilities for the convenience of consumers?

As I testified, consumers have a basic interest in securing the best and most efficient financial services system possible; a system that satisfies our needs for convenience, the best return on our deposits, and the lowest cost for services provided. If banks are not authorized to broaden the services which they can offer, we believe that objective, including the industry's ability to maintain convenient branch offices, will be undermined.

Profits lie at the heart of our industry's soundness. Profits are used to build capital, to shore up reserves when necessary and of course to pay a fair return to shareholders, thus ensuring the continued supply of a new capital when it is needed to support economic growth. The key to profitability is competition that is fair and free. The way to achieve fair competition is deregulation.

b. What will be the impact on the ability of the industry to raise capital and what will be the impact on the riskiness of the industry?

Consumers also have a basic interest in assuring that our nation's financial system is safe and sound.

Over the long term, if capital does not grow, the industry cannot remain safe and sound. Diversification into new consumer services is the way to produce earnings and

build capital. Diversification also is one of the keys to strength in our modern economy. Put in the simplest terms, it is necessary to diversify the business of banking precisely because that is one of the best ways of reducing risk.

9. You mention ABA's belief that additional securities powers for banks would promote competition in the financial services industry. You also note that safety and soundness must be of overriding concern. Are there any provisions of Title I of S. 2851 or new powers that you believe should be strengthened to promote safety and soundness? Do you think that the bank supervision system is presently adequate to maintain safety and soundness, if new powers are enacted?

The ABA believes that the provisions of S. 2851 which required that new activities be conducted in a separate subsidiary of the bank holding company, in combination with that bill's proposal for a new Section 23-B of the Federal Reserve Act to assure adequate restrictions on transactions with affiliates, provide an adequate framework for reducing risk to acceptable levels in the context of new products and services. Financial intermediaries cannot avoid risk; in fact, the primary service they provide to our economy is to assume and then reduce risk through analysis, evaluation, and diversification. Likewise, the fortunes of a bank can never be entirely separate from those of its parent holding company and the subsidiaries and affiliates thereof. However, an adequate statutory framework can assure that the federal deposit insurance funds are neither liable for any additional risk associated with new products and services, and that they do not subsidize bank entry into those activities. Regardless of the Congress' eventual decisions in regard to the reform of the deposit insurance system and/or the restructuring of the bank regulators, we believe that the supervision and examination of the system will be fully capable of maintaining the safety and soundness of banks as their parent organizations are permitted to enter into new fields of financial competition.

JAMES G. CAIRNS, JR., President, Peoples National Bank of Washington, Seattle, WA; President, American Bankers Association

Questions from Senator D'Amato - June 19, 1985

1. The Glass-Steagall Act was viewed by its proponents as an integral part of the effort to restore public confidence in the banking system after its collapse in 1933 and to protect depositors by insuring the stability of commercial banks. In particular, the Act's substantial separation of commercial and investment banking was designed to eliminate the problems and abuses Congress believed were associated with commercial banks' securities activities. Do you believe that Act was too sweeping and that the problems it was meant to solve could be addressed with other legislation? Would this enhance the banking industry? Would the consumer benefit?

The severe depression that began in 1929 and the collapse of the banking system that soon followed cannot be linked in any serious way to the fact that a number of banks were engaged in investment banking.

There were, to be sure, risks connected with bank participation in investment banking, and Congress clearly wanted to eliminate them by eliminating the activity so far as banks were concerned. At the same time, however, it instituted a separate and comprehensive set of reforms -- both in banking law and in securities law -- which themselves eliminated the same risks, or reduced them to manageable terms. If the sole reason for the Glass-Steagall Act is to protect the safety and soundness of banks, it is clearly unnecessary in 1985.

Moreover, in order to ensure that the new securities powers for bank holding companies contained in S. 2851 were not engaged in an unsafe or unsound fashion, or in any anti-competitive fashion, a number of restrictions were passed, including the requirement that the new powers had to be engaged in through a bank holding company or one of its nonbanking subsidiaries or affiliates rather than through a commercial bank itself. Placing the new services in a bank holding company subsidiary or affiliate would insulate the bank from any possible increase in risk associated with such services.

We believe that bank holding companies would benefit from removing artificial barriers to competition that today block them from competing fully, efficiently and effectively in the fields of securities, insurance and real estate. In the field of securities, bank holding companies should be allowed to offer mutual funds, and underwrite and deal in municipal revenue bonds, mortgage-backed securities, and commercial paper.

We believe that consumers would also benefit. As I testified, we have estimated that the customer who uses a bank-affiliated discount brokerage service saves about $250 a year in commissions over the customer who goes to a full service broker. Nationwide, that could work out to be about $130 million in savings for consumers each year. Furthermore, we believe that additional savings would be generated for consumers if bank holding companies were able to offer securities services such as underwriting revenue bonds or managing mutual funds.

2. Those who oppose the affiliation of banks and securities firms maintain the conflicts of interest resulting from such affiliations justify the preservation of the Glass-Steagall Act. Banks have long faced potential conflicts of interest, particularly between their commercial lending and trust activities. Securities firms face comparable potential conflicts in their various roles as underwriter, broker, dealer, and investment adviser. Do you believe that divorcing the two, because of potential conflicts, imposes unnecessary costs on society?

Our Association believes that divorcing banks and securities firms does impose unnecessary costs on society.

For example, when Glass-Steagall was enacted in 1933, state and local governments, with rare exception, issued only general obligation bonds. In enacting a basic prohibition against bank underwriting of securities, Congress specifically excluded from the prohibition such general obligation bonds. Even by 1933, revenue bonds constituted only about two percent of state and local obligations outstanding. But today, the market has changed. Now approximately 75 percent of the bonds issued are revenue bonds. Thus, the law must be changed if banks are to continue to serve state and local governments in raising needed capital funds.

There are several reasons why state and local governments would realize cost savings if bank holding companies were allowed to underwrite revenue bonds. First, the added competition would result in lower underwriting fees. Second, bank holding company participation would add liquidity to the secondary market, thus reducing interest costs. And third, bank holding company participation would expose these issues to new investors, which would reduce interest costs by increasing the size of the market.

The inability of the smaller investor to participate in the market for equity investments in a efficient and effective manner is another example of imposing unnecessary costs on society. If bank holding companies were permitted to sponsor, operate, advise and sell mutual funds, they would be able to provide the smaller investor the professional knowledge and experience of their trust departments, lower securities transaction costs, and greater investment diversification.

3. In recent months there has been a growing number of bank failures throughout the nation. In some states entire bank systems have come under suspicion. It seems each time a small bank faces financial trouble, a large out-of-state bank moves in. When an entire system fails, as was the case in Ohio, large interstate banks move in to straighten out the situation. For all practical purposes, interstate banking is proceeding, despite the lack of congressional action on the subject. I am hoping that as financial experts you could provide additional insight into this matter. Do you believe consumers will benefit? Will interstate banking provide safer banking?

The ABA believes that a move to interstate banking, tied to closure of the nonbank-bank loophole and authorization of new products and services, would -- on balance -- benefit consumers, the economy and the security of the nation's financial system.

Consumers would benefit from interstate banking, and the other legislative action that ABA is recommending, through lower prices that would result from increased competition, availability of more and better financial products and services, and the productivity that effective application of technology will bring into effect.

As I testified, we also believe that further deregulation of banking will significantly enhance safety and soundness -- the paramount public policy concern. Deregulation as advocated by ABA would diversify banking -- not only in terms of products and services offered, but also in terms of geographic location. Diversification would spread risk, generate new sources of earnings and over the long term strengthen the capital base. All three are necessary.

Spreading risk means operating in more than one or a few lines of business. When this happens, earnings in one area can cushion the impact of downturns in other areas. Spreading risk further by operating in more than one limited geographic area strengthens the equation even more -- when one local economy suffers a setback, earnings derived from operations in other communities allow the business process to continue unimpeded.

New sources of earnings also help to balance the net interest margin squeeze that has been created by deposit interest rate deregulation, again strengthening safety and soundness. The ultimate importance of earnings -- over and above paying shareholders a return sufficient to assure future access to new capital -- is that earnings can be applied to capital and set aside in reserve accounts, which are the first line of defense of the industry's safety and soundness.

JAMES G. CAIRNS, JR., President, Peoples National Bank of Washington, Seattle, WA; President, American Bankers Association

Questions from Senator Proxmire - June 19, 1985

Corporate Checking Accounts for Thrifts

1. On page 21, you say the ABA is "strongly opposed" to allowing federally chartered savings and loan associations to offer checking accounts to their business customers. Why is the ABA strongly opposed to this provision? It certainly seems closely related to what the savings and loan associations are already doing.

Granting full checking account authority to savings and loan associations would give them virtual parity with commercial banks in products and services. However, savings and loan associations operate under a significantly less restrictive regulatory structure. For example, the capital requirements for savings and loans are considerably less stringent than the capital requirements for banks. Another regulatory advantage of savings and loan associations is their access to the Federal Home Loan Bank advances mechanism as a source of long-term funds.

Also, through their service corporations, federally chartered thrift institutions have fairly broad real estate equity powers not available to national banks. They also have broader insurance authority than national banks. In addition, unitary savings and loan holding companies have no restrictions on the activities in which they can engage.

Furthermore, there are no federal statutory restrictions on the branching of thrift institutions, and in general, federal savings and loan associations have been allowed to branch anywhere within a single state regardless of state laws. In many states, commercial bank branching is much more restricted.

For these and other reasons, we believe that savings and loan associations should not be given broader demand deposit authority until they are regulated more like commercial banks.

Concentration Limits

2. The House bill on interstate banking would prohibit interstate acquisitions on the part of bank holding companies with more than 1 percent of total domestic bank deposits. It would also preclude mergers among the top 25 bank holding companies. What are the views of your association on these limits? Do you support them, and would you support the House measure if they are left in the final legislation?

Our Association believes that the current anti-trust laws are sufficient to protect the banking industry from any undue concentration of economic power. Banking is among the least concentrated industries in this country under existing law, and almost no rational scenario can be developed which envisions the type of growth and concentration in the industry that would significantly lessen its competitive nature. Therefore, we do not support the concentration limits included in the House bill on interstate banking. Our position on final legislation would depend on the overall package.

Foreign Deposits

3. As you know, the large money center banks are not charged any FDIC premiums against their foreign deposits even though these deposits have de facto 100 percent insurance as we saw in the case of the Continental Illinois Bank. Last year, I introduced an amendment to bring these foreign deposits under the FDIC premium base. I asked for the ABA position at that time, and you indicated you wanted more time to think about it. You have now had about nine months to think about it. Have you arrived at any conclusions?

We believe that the question of bringing foreign deposits of U.S. banks under the FDIC premium base should not be considered in isolation. Because our Association is scheduled to testify before this Committee in September on the nation's deposit insurance system, we would like to defer any specific comments on this issue until that time.

Interest on Demand Deposits

4. Both you and Kenneth Roberts (Association of Bank Holding Companies) conclude that deregulation has been a positive force and you recommend that Congress continue to de-regulate the banking industry. You both argue that there is really no other choice. Would your position on continued de-regulation extend to include lifting the prohibition on interest on demand deposits?

The American Bankers Association has supported and continues to support the deregulation of financial institutions in ways that allow those institutions to better serve their customers. However, the Congress has long recognized that deregulation of deposit interest rates must take place in an environment that allows depository institutions to offset the resulting increase in interest expense. Otherwise, deregulation of deposit interest rates could threaten the safety and soundness of our financial system, and would force a disproportionate share of the adjustment burden on one or more groups of bank customers such as small business, consumer, and agricultural borrowers.

Consequently, we believe that the proposed legislative changes contained in our written statement, which include closing the nonbank-bank loophole, expanding banking's authority to offer new products and services, allowing for geographic expansion, preempting state usury ceilings, and paying interest on reserves, are needed before lifting the prohibition on interest on demand deposits can be considered.

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William S. Edgerly
Chairman
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1985 AUG -7 AM 9:04

August 2, 1985

The Honorable Jake Garn
United States Senate
Washington, D. C. 20510

Dear Senator Garn:

I am writing to respond to questions submitted to me in your letter of July 1, 1985 in connection with the June 19 hearing of your Committee on changes in the financial services industry. My response is limited to Questions 9-12 on your list dealing with payments system risk. Your other questions, as well as those of Senator D'Amato, deal with matters beyond the scope of my testimony. I have responded directly to Senator Proxmire's question and am enclosing a copy of that letter. I am also enclosing a copy of my letter to Senator Heinz responding to a question which he posed to me during the hearing together with two reports of the Association of Reserve City Bankers concerning risks in the payments system.

Question 9: Please list each area of increased risk to the payments system which concerns you.

The key risk to the payments system is that the Federal Reserve, and indirectly the American public, could suffer losses if a depository institution were unable to settle its FedWire or private wire system position by the end of the day. When unregulated companies are able to use their own depository institutions to access the payments system, this settlement failure risk is increased. Such a depository institution can expose the payments system to whatever uncontrolled risks are inherent in its parent's unregulated business.

The Federal Reserve Board is requesting participants in the payments system to adopt voluntary limits on FedWire overdrafts and on net obligations to other participants, so-called bilateral limits and net debit caps. While these measures reduce settlement failure risk, they will not eliminate it. Their effectiveness requires rigorous new operating procedures, heightened awareness of creditworthiness on the part of all users of the payments system, and ongoing monitoring as part of the regulatory process.

Question 10: How are each of these risks mitigated by bank holding company regulation? Are or can these functions be administered by the regulator of the depository institution? Why or why not?

The risk that a depository institution will fail to settle is largely a function of the financial condition of the depository institution and its holding company. Holding company regulation limits the permissible activities of a holding company. This reduces the range of risks to which its captive depository institution can be exposed by processing payments for its parent. In addition, holding company regulation involves examination, monitoring, and control of capital adequacy, riskiness of assets and liabilities, and operating procedures of the holding company. Transactions between holding companies and their depository institutions are examined, monitored and controlled. This regulation contributes to financial strength of the holding company and thus decreases the risk to the depository institution from processing payments for its parent.

If all state and federal regulators of depository institutions were required by law to regulate the activities of the parent holding company, and to examine, monitor, and control risk at the holding company level, the risk to the depository institution from processing payments on behalf of its parent company would be controlled. However, there is presently no such requirement. Only bank holding companies and savings and loan holding companies are required by law to be regulated.

Question 11: What specific legislative solutions do you recommend? Should your proposed solutions apply to all owners, officers, and directors of a depository institution with regard to any nonbank activity in which they have an interest?

We believe that this problem should be dealt with by preventing an unregulated holding company, by which we mean a company not regulated to the same extent as a bank holding company or a multiple savings and loan holding company, from using any affiliated depository institution to process its payments. Attachment A of my enclosed letter to Senator Heinz contains specific statutory language.

As a practical matter, the major risk to the payments system, as measured in terms of dollars and likelihood of occurrence, is from unregulated corporate ownership of depository institutions. We do not presently believe that owners, officers or directors pose major risks to the payments system and would not, therefore, extend our proposals to these persons.

Moreover, it would be impractical to prevent depository institutions from processing payments on behalf of individual owners. Ownership of depository institutions is often widely dispersed. Similar practical considerations have dictated against applying bank holding company regulation to individuals who own depository institutions.

Corporate, creditor rights, and securities laws require that owners, officers and directors exercise objective credit judgment when using the depository institution to process their own payments or payments of businesses in which they have a significant interest. We would expect regulators of depository institutions to guard against the limited number of cases in which individuals might use the payments process to expose depository institutions to undue risk. At the same time, reliance on these general laws and regulations to deal with the risks posed by unregulated corporate ownership of depository institutions is, in our opinion, inadequate.

Question 12: Please describe every type of institution which has an account with the Federal Reserve and/or direct access to the FedWire?

Since 1980, Federal Reserve services, including the use of clearing accounts and direct access to FedWire, have been legally available to "depository institutions," as defined in Section 19(b) of the Federal Reserve Act, 12 U.S.C. 461(b). The term includes (1) any bank insured by or eligible for FDIC insurance; (2) any mutual or other state savings bank; (3) any credit union insured by or eligible for insurance by the National Credit Union Insurance Board; (4) any institution which is a member of the Federal Home Loan Bank; and (5) any institution insured by or eligible for insurance by the Federal Savings and Loan Insurance Corporation. Federal governmental agencies also have Federal Reserve accounts used for funds transfers since the Federal Reserve acts as a fiscal agent for the government.

This answer only addresses accounts used for funds transfers, on the assumption that other types of accounts, e.g. accounts payable, are beyond the intended scope of your question.

I am grateful for the opportunity to respond to these important questions.

Sincerely,

W S Edgerly

WSE:r

BANK OF NEW ENGLAND
CORPORATION

Walter J. Connolly, Jr.
Chairman

July 31, 1985

The Honorable Jake Garn
United States Senate
Chairman, Committee on Banking,
Housing and Urban Affairs
504 Dirkson Office Building
Washington, DC 20510

Dear Senator Garn:

I greatly appreciated the invitation to testify before your Committee last month and I welcome the opportunity to provide additional information in response to the questions posed by you and Senator D'Amato.

Questions Posed by Senator Garn

1. In your opinion, is the continued blurring of the lines between banking, insurance, and securities inevitable? Why?

   A. Products and services of the three industries will become more alike in the future, but the fundamentals of the businesses are likely to remain distinct unless there is substantial new legislation.

2. Should Congress authorize joint ventures among and between participants in the bank, insurance, and securities industry? If so, what types of joint ventures should be permitted?

   A. Unless the legal separation of the industries is removed, it is hard to see real opportunities for true joint ventures--as distinguished, for example, from cooperative arrangements in which the products of a firm in one industry are made available to the customers of a firm in another industry.

3. Many analysts claim that commercial and personal loans are in the process of being "securitized". They point to commercial paper, mortgage backed securities, auto loans, and junk bonds. Do you agree?

   A. There is probably a good deal less "securitization" than may have been suggested. Bonds and commercial

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paper are traditional financial instruments. Only one or two auto loan syndications have been reported. On the other hand, the sale of mortgage-backed securities by banks and particularly thrift institutions has been a very positive development, bringing much greater liquidity to the mortgage market and helping to protect financial institutions from the very serious consequences of mismatches of rates and maturities.

4. Commercial banks in London, including affiliates of U.S. banks, can engage in a broader range of investment banking activities than commercial banks in the U.S.

   a. Are you aware of serious safety and soundness problems that have arisen from these investment banking activities in London? Conflict problems? Why or why not?

      A. During the early 1970's when there was a serious collapse of property values in London, a number of United States-owned merchant banks experienced difficulties. Some observers believe that the problems encountered by one wholly-owned subsidiary of a large American bank led ultimately to the sale of the parent American bank to a foreign bank holding company.

   b. Does a financial institution operating in London have a competitive advantage over one operating in the U.S.? If so, have banks in the U.S. lost business to English affiliates or competitors?

      A. Financial institutions operating in London do have some competitive advantages over those operating in the United States alone, but most major U.S. banks have London presences, thus eliminating a good part of the advantage that would otherwise be enjoyed by British institutions. It is probably true, however, that the U.S. banks with London presences enjoy a competitive advantage over the smaller U.S. regional banks which lack them.

5. It has been reported that foreign banks now originate more than 40% of the commercial loans to U.S. domestic corporations in the New York market. Is this true? If so, why?

   A. Figures of 30% to 40% have been reported. They sound high, but if they are true, they probably apply to loans to large multinational firms borrowing in the New York market. The reality is that foreign banks are not

a competitive factor in the areas where most of our business originates.

Foreign bank branches in New York City typically enjoy cost advantages because of limited staffing and low overhead and, therefore, are able to operate profitably at lower margins. Their market strategy is essentially a limited one as opposed to full service, and they have adroitly skimmed the cream from the large corporate market. In addition, some foreign banks are government owned and appear to operate from a basic philosophy which is somewhat less profit oriented than privately owned U.S. counterparts. There is some evidence that even privately owned foreign banks are driven more by market share considerations than profitability. Many foreign banks (Italian/Japanese) are much more highly leveraged than U.S. banks (assets 50 times capital as opposed to 17 times) and, therefore, can operate incrementally at lower margins.

5. In his testimony James McCormick, President of First Manhattan Consulting, indicated that capital and reserve requirements coupled with having to pay market rates on deposits is beginning to make the traditional bank profit formula obsolete. Do you agree? Why or why not?

A. I don't agree. The traditional bank profit formula still works for Bank of New England Corporation and, I believe, for most other banks. We have modified some of the variables to reflect changed conditions such as the higher cost of funding as a consequence of deregulation, and we have increased our fee income. On the other hand, for us and for most other banks, net interest margin is still probably the single most important component of profitability or lack of it.

7. Why should bank and thrift holding companies be given the authority to underwrite and distribute mortgage backed securities, particularly in light of Bank of America's problem in this area?

A. For the reasons mentioned in the answer to Question 3, the underwriting and distribution of mortgage-backed securities can make an important contribution to the liquidity and safety of banks and thrift institutions, particularly those heavily involved in real estate lending. My understanding is that the Bank of America's problems arose in connection with their activities as custodian of mortgages made by others, not mortgage loans made by the Bank of America itself.

8. The legislation which passed the Senate last fall provided for a very modest expansion in the range of services that banks could offer their customers, but it was a step in the right direction. If banks are not authorized to broaden the services which they can offer:

---

a. What will be the impact on banks' ability to maintain expensive brick and mortar facilities for the convenience of consumers?

A. I believe banks will still be able to maintain their facilities doing the business they do now. The modestly expanded powers provided in the bill which passed the Senate overwhelminingly (e.g. the underwriting of revenue bonds and mortgage-backed securities) were not sought to support bricks and mortar, but because they were in the public interest. They would have broadened markets and have been a natural expansion and extension of existing powers.

b. What will be the impact on the ability of the industry to raise capital and what will be the impact on the riskiness of the industry?

A. In our view these powers would have very little effect either in enhancing the ability of the industry to raise capital or in increasing risk.

Questions Posed by Senator D'Amato

1. The Glass-Steagall Act was viewed by its proponents as an integral part of the effort to restore public confidence in the banking system after its collapse in 1933 and to protect depositors by insuring the stability of commercial banks. In particular, the Act's substantial separation of commercial and investment banking was designed to eliminate the problems and abuses Congress believed were associated with commercial banks' securities activities.

   Do you believe the Act was too sweeping and that the problems it was meant to solve could be addressed with other legislation? Would this enhance the banking industry? Would the consumer benefit?

   A. The Glass-Steagall Act may need some adjustment and fine-tuning to reflect current conditions, but we believe that separation of the securities business and commercial banking has generally been a sound public policy that has worked well and contributed substantially to the safety and soundness of the banking industry and the efficiency of both industries.

2. Those who oppose the affiliation of banks and securities firms maintain that conflicts of interest resulting from such affiliations justify the preservation of the Glass-Steagall Act. Banks have long faced potential conflicts of interest, particularly between their commercial lending and trust activities. Securities firms face comparable potential conflicts in their various roles as underwriter, broker, dealer, and investment adviser.

   Do you believe that divorcing the two, because of potential conflicts, imposed unnecessary costs on society?

   A. For the reasons mentioned in the answer to Question 1, we believe that the industries should remain generally separate. We believe that the benefits of separateness greatly outweigh the minor inefficiencies and redundant costs.

3. In recent months there has been a growing number of bank failures throughout the nation. In some states entire bank systems have come under suspicion. It seems each time a small bank faces financial trouble, a large out of state bank moves in. When an entire system fails, as was the case in Ohio, large interstate banks move in to straighten out the situation.

   For all practical purposes, interstate banking is proceeding, despite the lack of congressional action on the subject. I am hoping that as financial experts you could provide additional insight into this matter. Do you believe consumers will benefit? Will interstate banking provide safer banking?

   A. Not necessarily. I believe the principal advantage of interstate banking lies in the ability to provide increasingly expensive services at lower cost by virtue of spreading the cost over a larger base, i.e. economies of scale. It is uncertain to me when economies of scale cease and bureaucratic waste commences. This is why I think the "New England Experiment" is a sound transition phase that will enable Congress to evaluate and regulate the pace at which interstate banking is proceeding without going too far too fast.

I hope these responses may be of some help in your deliberations. I would be glad to supply any further information you might require.

Sincerely,

Walter J. Connolly, Jr.

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August 21, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the Western Independent Bankers we very much appreciate the opportunity to participate in the legislative process begun with your Committee's hearings on changes in the financial services industry. We have just received the written questions prepared by members of the Committee in connection with the written record of this hearing. Our responses are set out in the attachment.

WIB is striving to be an effective voice for independent community-type bankers in the West and we hope that our appearance before your Committee will aid in the development of legislation that recognizes the unique banking experience that our members have accumulated over the years and our readiness to meet new challenges to the traditional banking profession.

Sincerely,

Bill Hickman

John W. "Bill" Hickman
Immediate Past President

c: WIB Board of Directors
R. Blair Hawkes

WRITTEN RESPONSES
TO
QUESTIONS FROM JUNE 19, 1985 HEARING

QUESTIONS FROM SENATOR GARN

1. It is my opinion that the blurring of the lines among banking, insurance and securities activities is going to continue. It is very difficult to return to previous separations after overlap has begun. The close relationship among all of these products, the manner in which customers utilize them, and the efficient manner of presenting them to potential customers seems to insure that the crossing over of artificially imposed lines among these activities will continue.

2. Congressional permission for joint venturing among banking, securities and insurance industries seems appropriate since there are effective ways for the participants to operate in concert already. There is clearly already a great deal of opportunity for these industries to work together.

3. No doubt the secondary markets being created for the resale of commercial and personal loans does seem to "securitize" the actions taken, but there is no danger being presented by this activity which naturally follows the course of normal banking endeavors.

4. While I am not professionally involved in the London commercial banks' activities, I am not aware of any difficulties that have occurred that would indicate that broad investment powers have been anything but a positive force on these banks. No conflict of interest problems have been apparent. With regard to the competitive advantages of financial institutions operating in London over those in the United States, I can only surmise that the broader powers make those institutions more competitive and stronger through their diversification abilities. I do not have any knowledge of specific competitive losses in this country to foreign institutions.

5. The loan market that we serve from the Dixie State Bank in St. George, Utah, and those that most of WIB member banks serve are not particularly impacted by the influence of the foreign institutions. The quoted figures, however, seem reasonable in light of our general impression about the New York market.

6. Absolutely. The bank of today must adopt very new and dynamic approaches to the business of banking in order to survive today. Traditional formulae no longer assure success, much less survival. Without expanded service opportunities and the flexibility to select from among the growing menu of financially-related products that our customers need and want, we shall be left far out of the competitive scene.

Question 6 (continued)

The argument based upon "safety and soundness" considerations should actually favor the expanded service concept. The economic vitality of the banks that we represent is highly reflective of their ability to tailor their services and meet changing customer needs. Without that ability to alter old formulae and to develop new areas of business, the safety and soundness of the very institution itself is threatened.

7. Banks should be granted the authority to underwrite and distribute mortgage-backed securities to the extent that they meet reasonable guidelines and are subject to appropriate supervisory oversight. The mortgage-backed security is an extension of the real estate lending expertise of the financial institution and is not more dangerous than the lending itself if treated with similar respect and professional constraints.

8. Obviously the failure of the Congress to adopt the Senate-passed legislation has a negative impact on the banks that we represent. While they have not invested as heavily as some other institutions in the so-called "bricks & mortar" facilities, they are sensitive to the impact. It does operate against their ability to expand their facilities --drive-up windows, ATMs, loan production offices, etc.,-- when some expansion would be good for the bank and its service area. Many of our members are in areas that are less fully served than some of the more populous cities and suburbs. Establishment of "facilities" in these conditions is more than just customer convenience. For some it is the only banking facility available in many miles. The need for "full service" operations is even greater in these remote areas that do not have the customer base to support a larger number of specialized institutions catering to specified customer needs.

Investors will be more reluctant to invest in institutions with regulatory limitations that unreasonably inhibit growth opportunities in a changing marketplace. The "riskiness" will be based more upon the fact that the financial institution will not be allowed to compete or will be constrained while its competition is permitted to develop, rather than a "risk" of overextension beyond capabilities.

ANSWERS TO QUESTIONS FROM SENATOR D'AMATO

1. Without commenting upon the Act relative to its appropriateness at the time of passage, I would say that time and circumstances have so altered the conditions surrounding both banking and the sale of securities, that application of the Act in today's environment may not be the best solution to legitimate concerns expressed about the appropriate separation of certain financial services. The consumer benefits from choice of products and the multiplicity of sources of supply. Coupled closely with these elements must be the knowledge of the relevant facts concerning interest of the parties involved and the level of assurance that investments are insured or otherwise guaranteed. If there is no misunderstanding or failure to properly disclose relevant facts, there should be no particular danger to the consumer in the sale of securities by banks. Abuse can be dealt with regulatory or legislative provisions that would be developed as experience indicated some need for additional intervention.

2. Artificial distinctions between securities sales and banking does impose added costs on the consumer in that the economies of combined operations in one institution can provide cost effective savings to the consumer. Expansion of banking authority into this area gives the bank a broader base of financial support and increased exposure to marketing opportunities well within the capabilities of the industry. Naturally, appropriate regulatory supervision of the securities sales personnel and their operations, as with anyone performing these functions, will ensure uniform oversight protection.

3. The perception that some large out-of-state bank moves in whenever a small bank is in trouble is not the reality. For years through a procedure of "Purchase and Assumption" banks have rescued other banks. The procedure has allowed depositors to benefit from the joint action of the industry and the administrator's underwritten deposit insurance system (the FDIC). The case of the large out-of-state bank coming into the picture is far more the exception than the rule.

   We would, however, agree that interstate banking is already here in many respects. We support the expansion of interstate agreements that are leading to the elimination of state geographical barriers to a full interstate banking system. We oppose any diminishment of the states' authority to charter and supervise institutions that operate under the laws and regulations promulgated in that state if they chose that forum. A "Federal trigger" to effectively remove state control over the banking institutions operating in the several states is highly detrimental to the dual banking system that underpins the banking industry in this country. Ultimately, states will, by their own initiative and economic pressures, develop a fully interstate reciprocity format to accommodate dual banking supervision with full interstate operations. We feel that this development should evolve from within the states themselves allowing for the transitions necessary to provide well-based and sound economic justification among the participating institutions. Merger mania will result from an unnatural interstate triggering element in Federal legislation at this time. Business plans will marketplace justification for expansion, acquisition, and restructuring of existing institutions.

The consumers will benefit from the positive effects of deregulated banking including interstate operations, but the geographical expansion should be allowed to come about through a natural marketplace development supported by customer demands and reasonable dual banking supervision of the process.

We do have additional witnesses. Panel 2 is composed of Mr. John B. Carter, president and chief executive officer, the Equitable Life Assurance Society of the United States; and John B. Crosby, general counsel, National Association of Independent Insurers.

Mr. Carter, would you like to begin?

STATEMENT OF JOHN B. CARTER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE EQUITABLE LIFE ASSURANCE SOCIETY OF THE UNITED STATES, ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. CARTER. Thank you, Senator.

First, I'd like to fully agree and applaud the statements you just made and again, from a personal point of view, I hope you go too far rather than not far enough in that direction.

[The complete prepared statement follows:]

STATEMENT OF THE

AMERICAN COUNCIL OF LIFE INSURANCE

Before the

COMMITTEE

on

BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

on

FINANCIAL SERVICES INTEGRATION

June 19, 1985

Statement Made By:

John B. Carter
President and Chief Executive
Officer
Equitable Life Assurance
Society

Mr. Chairman and Members of the Committee, my name is John B. Carter, and I am the President and Chief Executive Officer of the Equitable Life Assurance Society of the United States. I am appearing today on behalf of the American Council of Life Insurance, whose 615 member companies have approximately 95% of the life insurance in force in the United States and 97% of the insured pension business.

I am pleased to be able to offer the views of the life insurance industry on the subject of banking deregulation. I appeared before this Committee in the same capacity just over one year ago, and I am bringing you essentially the same message as I did then but with a bit more urgency.

Erosion of Congressional Authority

For over two years, Congress has been debating the issue of so-called "loopholes" in the federal banking statutes. Use of these loopholes by aggressive financial institutions (and acquiescence if not outright encouragement of such actions by a few compliant "regulators") has resulted in a financial services industry marked by competitive inequities, potentially grave marketplace risks, a general sense of uncertainty, and an alarming loss of public confidence in the nation's banking system. Perhaps the most troublesome by-product of this process has been the gradual but steady preemption of Congress from its traditional role in formulating national banking policy.

Congress needs to act immediately to close the real or perceived legal loopholes which banks and others are attempting to exploit and to rein-in those regulators who have arrogated unto themselves the Congressional prerogative of setting national banking policy.

Some witnesses before this Committee in previous hearings have expressed the view that it is too late for Congress to try and stop the runaway train of deregulation, concluding that all that can be done is to open the switches and let it go wherever it wants.

We strongly disagree with that notion. Congress has the ability and the duty to establish a fair and orderly framework for the financial services marketplace without regard to the latest fad among bankings "go-go" fraternity. Most of those within the financial services industry who say the process cannot be stopped are simply reflecting the view that Congressional inaction will further their parochial interests. At least until a calamity occurs, these people would like nothing better than to see Congress operate as little more than a rubber stamp of marketplace initiatives.

We believe it would be a serious mistake for Congress to allow the evolving financial services marketplace to be shaped solely by institutional self-interest. The risks of such a

course of action are greatly compounded by the lack of caution exhibited by the banking regulators and the lack of consideration being given to the consequences for nonbanking financial intermediaries.

Congress can and must step in now to apply the brakes and to allow reason, rather than deregulation euphoria (which should have been tempered by the unfortunate experiences in the telephone and airline industries) to dictate the structure of our financial institutions.

Recent Events Argue Against Deregulation

Like other private citizens, those of us in the life insurance business get very alarmed when events like the collapse of Continental Illinois and the panics in Ohio and Maryland graphically demonstrate the fragile nature not only of the banking system but also of the public's confidence in that system.

We are not suggesting deregulation as the cause for these events or for the record number of recent bank failures or for the involvement of banks in the real estate and money laundering scandals which have received so much attention lately. All of these things can generally be attributed to mismanagement, fraud, or poor supervision.

What we cannot understand is why serious consideration would be given to bestowing additional powers on banks when it is painfully evident that their regulatory system is already severely strained and that they are having difficulty handling their current compliment of powers.

Despite the uncomfortably high number of bank insolvencies, the record number of banks on the "problem" list, and the acknowledged inability of bank regulators to adequately monitor existing banking operations and relationships, we read daily accounts of what appears to be a contest between the Fed, the Comptroller and the FDIC to allow banks to engage in ever more unfamiliar and risk-laden undertakings.

It hardly seems reasonable to suggest that the solution for poor decision-making in a substantial number of our nations banks is to give their managers more divisions to oversee. A preferable approach would be the immediate consideration of the regulatory reform proposals contained in the Bush Task Force report which, incidentally, are supported by all of the banking regulatory agencies.

Competitive Advantage for Banks

Do we want to keep banks out of insurance because we're afraid of competition? Absolutely not. Were insurers outraged about securities firms entering their business? No. About

retailers entering their business? No. About real estate firms entering their business? No. Why not? Because all of these types of businesses operate under the same basic ground rules as insurers. None have a financial back-stop underwritten by the Federal government. If they are talented at their business they succeed -- if not, they fail.

None of these entities has access to low cost funds through no-interest deposits, nor do they have access to the Fed's discount window. They do not have Federal Deposit Insurance, and when they fail they do not have the helping hand of the FDIC to merge them into a prosperous competitor. Banks, on the other hand, have all these protections and more. If you are a large enough bank, the regulators will simply not allow you to fail for any reason. Such is the luxury of the federal safety net.

It is perhaps an unintended effect of the safety net that banks are in some ways encouraged to take risks that they would not otherwise consider taking. This may be particularly true in the context of new powers. If most or all of the risk of failure can be laid off on the FDIC, then why not enter any business that has even an outside chance of showing a profit.

A system that operates in this way makes competition with banks very unfair for those of us lacking the federal safety net. When you add to that banks' advantage of no-interest deposit funding and the potential use of credit leverage, the prospect of competitive equity for other financial services providers becomes remote at best.

This is not in any way a complaint about the safety net itself. The public demands and deserves a secure payments system, and that is what the safety net is there for. Recent events certainly underscore the value of the system.

Clearly, however, the safety net was not intended to protect or enhance non-banking products sold by banks. Yet, as a practical matter, that is just what would happen either in terms of public perception or as a matter of law. A principal problem with allowing banks into other businesses has always been the difficulty of effectively insulating or segregating banking from nonbanking activities. This problem has been noted repeatedly by Federal Reserve Board Chairman Volcker and others in testimony before this Committee. Even when a legal demarcation can ostensibly be made, it is extremely difficult, if not impossible, to ensure that there will be effective financial insulation or that the public will appreciate any distinction between the banking function and other functions. This problem would be exacerbated by permitting banks to engage directly in nonbanking activities as has been proposed by the FDIC and the Federal Reserve Board (see discussion of Proposed Rulemaking, below).

Walter Shipley, the Chairman of Chemical Bank testified earlier in these hearings that bank consolidation and streamlining would "save some $21 billion a year or 25 percent more than

the entire U.S. banking industry's after-tax profit in 1983." Such an effort to increase efficiency and lower costs without subjecting financial institutions and the deposit insurance funds to increased risks is a much more supportable objective than wholesale deregulation.

Why Close the Loopholes

The life insurance industry strongly believes that the various loopholes which some financial institutions are attempting to utilize to gain access to additional product markets must be closed.

Loopholes by their very nature involve the avoidance of statutory and regulatory controls which more often than not were intended by Congress to ensure the safety and soundness of the banking system or to maintain competitive equity.

It has been suggested that closing loopholes is not a fruitful undertaking since inventive lawyers will only concoct new loopholes to take their place. While I understand the frustration underlying such sentiments, I believe a different approach is called for. There will be lawyers searching for loopholes as long as there are laws. Even if the Congress passes a broad deregulation bill, there are going to be people looking for and finding loopholes to expand the universe of permissible activities still further and to avoid unwanted regulatory controls. The only difference is that they will be starting from a different baseline. It seems to me that if a law was worth enacting in the first place, it is worth taking the necessary steps to prevent its circumvention.

Moreover, when Congress fails to close a well-publicized loophole, such as the one created by Citicorp in South Dakota, it really amounts to an open invitation for the creation of additional loopholes. Its like saying "If you can find a loophole, it's yours; we won't take it away from you." With that kind of signal, it is a small wonder that companies like Citicorp spend a great deal of time trying to identify and exploit loopholes. Frankly, that is not the kind of research and development that Congress should be encouraging.

On the other hand, if Congress would act quickly and decisively to close loopholes on a retroactive basis, it is doubtful that so much effort would be spent trying to find ways to evade federal law.

Remedial action to close the nonbank bank loophole appears somewhat less urgent in view of a recent decision in the 11th Circuit that these hybrid institutions are improper. Legislation to clarify the definition of "bank" beyond any doubt should nevertheless be enacted. However, the practical effect of the 11th Circuit decision and the clear result of any legislative closure of the nonbank loophole would be to foreclose insurers from acquiring a banking capability. That being the case, it is

all the more important for reasons of competitive equity that bank holding companies be similarly prevented from exploiting other loopholes to engage in insurance activities otherwise prohibited to them by Title VI of the Garn-St Germain Act of 1982.

The exercise of insurance powers by banks is just as capable of undermining the safety and soundness of the banking system as is the use of nonbank banks by commercial institutions. The same concerns that argue against permitting the wholesale integration of banking and commerce through the use of nonbank banks apply to the use of South Dakota-type enabling legislation to frustrate the purposes of the Bank Holding Company Act.

The Dodd Amendment

The so-called Dodd amendment language which was part of S.2851 as passed by the Senate last year is strongly supported by all segments of the insurance industry, and we hope it will be included in any legislation which moves forward this year.

The Dodd amendment stands for the proposition that a bank holding company may not evade the activities restrictions of the Bank Holding Company Act simply by inserting a state-chartered bank between the holding company and the prohibited activity as is being attempted in South Dakota.

Every time the Dodd amendment is mentioned, however, its opponents produce the red herring of states' rights. This is not a states' rights issue. We are talking about the activities of companies which have opted to become federally-regulated entities subject to a federal statute, the Bank Holding Company Act (BHCA). This Act contains explicit restrictions on the extent to which these entities and their subsidiaries or affiliates may engage in insurance activities.

We are not advocating an end to the dual banking system. If the states wish to confer new powers on their resident banking institutions which are not part of a bank holding company system, that is their privilege. If we disagree with a particular proposal affecting free-standing state-chartered banks, we will challenge that proposal in the state legislature. But state-chartered institutions which elect to form federally-regulated bank holding companies cannot argue that they should be viewed the same as free-standing state banks.

There is no legal theory of which we are aware suggesting that state legislatures can determine which Federal laws their institutions should recognize and which they can ignore. Similarly, there is no provision in the BHCA which creates an intra-state carve-out for state bank subsidiaries of holding companies. In addition to operational considerations, there are two significant advantages that inure to a bank held in holding company form. The first relates to significant tax advantages they enjoy over free-standing banks in the financing of stock purchase

transactions, in effect, to be able to use before-tax instead of after-tax dollars to purchase shares of bank stock.

The second advantage relates to the avoidance of restrictions imposed by state law on branching, i.e., some states, pursuant to their regulatory objectives prohibit the establishment of branch banks. In most of those states an individual bank can nonetheless expand its locations within the state by forming a parent BHC under federal law and then using the BHC to acquire additional banks. In these instances BHCs are formed in order to permit the evasion of state law.

Now these same BHC's are contending that they do not have to observe BHCA restrictions because their subsidiary banks are creatures of state law. Unfortunately for those espousing this view, you cannot be subject only to the advantageous provisions of the BHCA and ignore its constraints. You simply cannot have it both ways.

Several other important points need to be made about the Dodd amendment. First, it would have absolutely no effect on free-standing state-chartered banks. Thus, state-chartered banks not affiliated with a BHC could continue to engage in whatever insurance activities their state legislatures permit. Second, the Dodd amendment leaves unchanged all the exemptions from the insurance restrictions contained in the BHCA which are already more generous than we would prefer. */ Hence, absolutely no restrictions on insurance agency activity would apply to more than 80% of all BHCs (those with less than $50 million in assets or principally located in small communities) and their subsidiary state banks. Only the largest BHCs would be subject to these restrictions.

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*/ Permitted under the exemptions are unlimited insurance agency operations for bank holding companies with less than $50 million in assets or which are principally located 1) in communities of 5,000 or less population or 2) where other insurance facilities are inadequate. Also exempted are insurance agencies which were in operation or approved before May 1, 1982, regardless of holding company size.

Significantly, the only insurance underwriting activity exempted relates to credit insurance. The purpose of credit insurance is to guarantee repayment of a loan to the financial institution itself in the event of the death or disability of the borrower. Because the bank or other lender is the named beneficiary, the underwriting and sale of credit insurance can serve to reduce the risks to which the institution is subject.

On the other hand, other types of insurance underwriting, for which the bank would not be the beneficiary, result in the creation of contingent liabilities and serve to increase the risks to which the institution is subject.

Opponents of the Dodd amendment are intimating that this is an instance of the insurance industry trying to disenfranchise some defenseless little state banks who are only trying to do what their legislatures permit and who happen, incidentally, to be part of a holding company. The truth is that if smaller BHCs want to operate an insurance agency through their state bank subsidiaries, they can. The main restrictions relate to underwriting, for which, as a practical matter, only the large BHCs are willing or able to make the necessary commitments.

In the context of States' rights considerations, the application of Citicorp */ to acquire a small South Dakota bank invested with insurance underwriting powers is something of a paradox. Assuming approval is ultimately granted for the acquisition, it will certainly not be the small South Dakota bank that is funding, operating and doing the corporate planning for the insurance operation. The fact is that the parent bank holding company would be operating the insurance department in every meaningful way, despite the express prohibitions in the BHCA against its doing so.

Before leaving this subject one more observation is in order. It has been suggested in previous hearings that since insurers are state-regulated and rigorously defend state regulation, it is inappropriate for them to advocate that state-chartered banks, even if it is only those that are part of a BHC, should be constrained by federal law, or that a state should be prevented from granting additional authority to its resident banking institutions in the manner contemplated by the Dodd amendment.

We have adequately covered the reasons why we do not agree that this is a states' rights issue. On the question of our intellectual consistency, however, the record needs to be set straight. Mr. Chairman, being "state-regulated" does not exempt or otherwise excuse insurers from all federal laws. The fact is that, like every other business, insurance companies and their products and services are subject to an expanding array of federal laws, rules and regulations. We comply with innumerable regulations promulgated by a long list of federal agencies -- Commerce, Labor, Treasury, IRS, SEC, FTC, HUD and so on. Among the federal statutes we labor under are specialized tax laws, ERISA, the Truth-in-Lending Act and the full range of federal securities laws to name only a few. For an industry that is supposedly state-regulated, we would seem to spend an inordinate amount of time dealing with the federal government. Please don't misunderstand. We strongly favor state regulation, but it hardly

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*/ Bank America's application to establish a South Dakota bank was withdrawn on June 10, 1985, leaving Citicorp as the sole remaining applicant.

can be characterized as a shield from federal regulation outside the very narrow areas of premium taxation, product forms, solvency assurance and certain antitrust aspects.

Proposed Rulemaking

Recent notices of proposed rulemaking by the Federal Reserve Board for real estate activities by bank holding companies and by the FDIC for insurance and real estate activities for insured banks serve only to highlight the problems of mingling banking and commerce.

Both regulators have indicated that under certain circumstances some of the proposed activities may be acceptable if conducted directly within a bank rather than in a separate subsidiary. Such an approach serves only to stand the concept of the bank holding company on its head.

Banking historians can attest that the purpose of creating the Bank Holding Company Act (in addition to preventing undue concentrations of economic power) was to permit banks to engage in certain non-banking activities only indirectly, through an upstream holding company which in turn would own downstream nonbanking subsidiaries. This structural insulation was considered necessary to facilitate separate regulation of the various entities, to prevent self-dealing and the co-mingling of assets, and to diminish the prospects for finding the bank financially liable for the activities of the nonbanking units.

Now the Federal Reserve and the FDIC propose to permit some nonbanking activities directly within a bank, where functional regulation, the assessment of liability, the prevention of self-dealing and the public's perception of discreet operating entities all become illusory concepts.

Does the FDIC intend to indemnify banks whose insurance department losses get them in trouble? Would it be required to do so as a matter of law? Could a bank afford to have its name associated with failure even if it is just its insurance division? How would the public react? Should a bank's insurance customers have their protections eroded because the bank used insurance proceeds to prop up losses caused by imprudent loan policies? Will the public appreciate that not all of a banks products are insured despite the "Federally insured" stickers posted in the lobby? Is the prospect for the use of credit leverage or tie-ins all the greater when all of the products are sold within a single business organization?

The already substantial problems and risks of mixing banking and commerce multiply when the commercial activities are permitted to be conducted directly within the bank.

The Comptroller Loophole

Mr. Chairman, recently the Office of the Comptroller of the Currency (OCC), issued two rulings which further complicate the already heated issue of insurance activities by banks.

The first ruling (technically an advisory opinion) examined whether a discount brokerage subsidiary of a national bank should be permitted to market variable annuities underwritten by an insurer. (Variable annuities are regulated insurance products which must additionally be registered as "securities" under federal securities laws). The OCC irrationally concluded that variable annuities are "not insurance", and, because of their securities characteristics, may be sold by discount brokerage subsidiaries of national banks just as other securities are sold. Because brokering variable annuity contracts does not involve "insurance", none of the insurance prohibitions of the National Bank Act or the BHCA would be applicable.

In the second ruling, the OCC determined that the underwriting of insurance to guaranty payments on municipal revenue bonds was the same thing as issuing standby letters of credit. Thus, it permitted Citicorp to acquire an insurance company, which in addition to underwriting insurance on municipal revenue bonds is licensed as a general property/casualty insurer in a number of states.

Both of these rulings were based on erroneous determinations by the OCC that the activities in question simply constituted the exercise of powers "incidental" to the operation of a national bank. In essence, the Comptroller was asked to conclude that an insurance activity was really a banking activity and not insurance. In both cases, this finding facilitated the circumvention of otherwise applicable insurance limitations of the National Bank Act and the BHCA.

Thus, we are faced with an abuse of discretion on the part of the OCC which threatens to undermine the protections of the banking statutes in the same fashion as does the South Dakota loophole.

While the latter OCC ruling is currently in litigation, insurers are examining the possibility of pursuing a legislative solution along the lines of the Dodd amendment.

The Financial Services Clarification Act

We were encouraged by Senator Mattingly's introduction of S. 716, the Financial Services Clarification Act, which, among other provisions, closes the nonbank bank and South Dakota loopholes. While we do not favor every aspect of the bill (particularly the grant of additional securities powers to banks in the form of commercial paper authority), we believe it is a responsible

approach which should receive careful consideration from the Committee.

That concludes my remarks Mr. Chairman. I would be happy to answer any questions the Committee might have.

The CHAIRMAN. Thank you, Mr. Carter.
Mr. Crosby.

STATEMENT OF JOHN B. CROSBY, GENERAL COUNSEL, NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. CROSBY. Thank you, Senator.

While the National Association of Independent Insurers has not taken an official position on any Federal legislation thus far introduced, we have maintained a deep interest and involvement in the financial integration process at the State and local levels.

Our position has been dictated by the diversity of our membership of 500 companies which range from the small, one-State property and casualty writers to the very largest national writers. They are stock, mutual, and reciprocal companies and have a mix of merchandising the insurance product from agency to direct writer to direct mail.

However, at your request, Mr. Chairman, we appear before you today to speak to what we feel would be the appropriate legislative response to the rapidly changing financial services industry as it affects insurance.

CONTINUE STATE REGULATION

First of all, Mr. Chairman, State regulation of the business of insurance must be maintained at all costs. The geographic and demographic differences in our Nation demonstrate the need for close, continuous and accessible regulation. State insurance departments have proven their ability to perform their responsibilities in the best interest of the consumers of the individual States.

If insurance is underwritten through a separate corporate affiliate of a bank holding company and regulated totally at the State level, we see very few bank entry problems arising from overlapping supervisory responsibility or conflicting regulatory requirements.

A two-headed regulatory system of banking and insurance, on the other hand, would lead to competitive inequities among insurers in the same market.

Second, any law in this area must effectively stop tie-ins. Explicit antitying statutes have been on the books for years but have singularly failed even against blatent tie-ins. FTC and Federal Reserve Board studies have verified that the Sherman Act and the Bank Holding Company Act have not curbed this abuse.

The passive tie-ins frustrates all attempts at legislative drafting. As long as a single bank organization is permitted to market connected insurance products, the evils of the passive tie-ins will persist.

Few borrowers, sophisticated or not, can miss the implication that purchasing insurance from a bank will help him or her obtain a loan. That is a form of coercion too subtle to prove or prevent and one that the bank cannot avoid exerting.

Last, as competition heats up in the financial services arena, banks will enter the fray with unfair advantages due to their legal monopoly over demand deposit accounts. These special powers to create and destroy demand deposits have already allowed a rela-

tively small number of commercial banks to accumulate assets that dwarf the resources of other financial institutions.

It is unfair to insurers to permit banks to acquire resources under a new franchise and then use them against competitors that have not enjoyed the banking privilege.

Mr. Chairman, Confucious wished that we may live in interesting times, and these are very interesting times but also confusing and unsettling. The NAII urges Congress to act and we are most willing to cooperate with you and your staff to fashion a final resolution to these issues. Thank you.

[The complete statement follows:]

Statement
of
John B. Crosby
Vice President & General Counsel
National Association of Independent Insurers
Before the Senate Committee on Banking, Housing & Urban Affairs
Oversight Hearings on Bank Deregulation
June 19, 1985

The National Association of Independent Insurers (NAII) is decidedly receptive to fair and equal competition in the marketplace. We are opposed, however, to deregulation at the expense of state regulation of the business of insurance or of the consuming public. Just as we are concerned about the threat to solvency and state regulation of insurance posed by the Treasury II tax proposal, we are concerned about the solvency and state of regulation in the financial services industry posed by bank deregulation.

INTRODUCTION

The NAII is a voluntary national property and casualty insurance trade association of more than 500 member companies. Our members range from the small one-state writers to the very largest national writers. They are stock, mutual and reciprocal companies and they have a mix of merchandising the insurance product from agency to direct writer and direct mail. Our members underwrite approximately 38% of the automobiles and 28% of the homes in our nation which are insured. Workers compensation and commercial lines are written but to a less significant degree.

INDECISION

Congress must address financial deregulation very soon. It was two years ago last week that we had the privilege of testifying on this same subject before your Committee. No one really knew then, nor do they know now, where this debate will finally lead us. It was conjecture then and it is conjecture now what the various financial entities will look like in the future. As then, we and all other interested parties are still in the process of sorting out events in the market place, which are running far ahead of the regulatory systems and in a legislative vacuum. Until Congress acts, the NAII and other insurance interests have but their fingers to put into the dike. A few examples will suffice:

* After the passage of the South Dakota law allowing state banks to underwrite property and casualty insurance directly, we have been embroiled at the Board of Governor of the Federal Reserve System opposing the applications of Citibank, First Interstate and Bankamerica to purchase or otherwise form South Dakota banks to accomplish insurance underwriting. We are convinced these acquisitions constitute violation of Section 4(c)(8) of the Federal Bank Holding Company Act. Last week we were informed that Bankamerica has withdrawn its South Dakota application. What does this mean?

* In the past several weeks two of our member companies, Verex Insurance Company and Ambac, entered into an agreement whereby Ambac reinsured the mortgage guaranty business of Verex and as part of the

agreement Citicorp purchased Ambac. This in effect will allow Citibank to underwrite property and casualty insurance through its subsidiary. Lo and behold Citibank may become a member of the NAII.

* The Eleventh Circuit Court of Appeals in the U.S. Trust case has denied the Federal Reserve Board's power to approve the purchase of a non-bank bank while the U.S. Supreme Court has opened the door to regional interstate banking. In the past several weeks an agreement has been reached in the other House Committee, outlining their thoughts as to the viability of non-bank banks.

Indecision breeds chaos and, unfortunately, that is the world of financial services today.

RECOMMENDATION

Mr. Chairman, we are in a maze of constant activity in all directions. Before matters get so far out of hand and complete chaos reigns, we urge Congress to address these issues and settle them for the foreseeable future. We do not believe that it is up to the states, the courts, or the federal agencies to address these problems. We believe that the responsibility for setting down and determining sound solutions in the financial deregulation area lies with Congress. Naturally, we will express how we believe this new world should be shaped. Whatever decisions are made by the Congress, we assure you that the property and casualty insurance industry will respond and compete vigorously.

PRINCIPLES

If and when banks are given the authority to underwrite insurance, competitive equality demands that the underwriting of insurance must be accomplished through a separate corporate entity and regulated entirely by the state insurance departments in place, without federal pre-emption or examination into the insurance operations. Conversely, insurers must have equal market access to the business of banking subject to the same regulatory bodies and rules applicable to banks. To this end, we stress the following points that will establish these requirements.

Separate Corporate Entity

It should be required that insurance may not be written directly within a bank or through a bank's subsidiary but only through a separate corporate "affiliate" within the bank holding company structure. Requiring an affiliate would allow for certain protections and restrictions on transactions built into the amendments to the Federal Reserve Act. The insurance regulators would more easily be able to identify and monitor the activities of an affiliate within the bank holding company structure than would be the case if they entity were a subsidiary of a bank within the bank holding company.

A bank holding company should be prohibited from purchasing an existing insurer and required instead to form an insurance affiliate de novo. This requirement would have the added advantage of bringing fresh capital into the insurance business. Our industry is under a severe and intensifying strain to increase its capacity to underwrite the risks that will be presented to us in

the future. Merely taking capital from an already capital starved economy and using it to purchase an existing insurer does nothing to add new resources to the insurance business.

Exclusive State Regulation of the Insurance Affiliate

The business of insurance is regulated exclusively at the state level. The geographic and demographic differences in our nation demonstrate the need for close, continuous and accessible regulation. State insurance departments have proven their ability to perform their responsibilities in the best interest of the consumers of the individual states. Insurance departments have ably administered their trust through market conduct examinations and vigorous enforcement of the unfair trade and claim practices acts. In the area of their prime concern, solvency, time and time again they have proven themselves up to the task. If insurance is underwritten through a separate corporate affiliate of the bank holding company and regulated totally at the state level, we see very few bank entry problems arising from overlapping supervisory responsibility or conflicting regulatory requirements. A two-headed regulatory system of banking and insurance on the other hand, would lead to competitive inequities among insurers in the same market.

Mr. Chairman, while we realize that this Committee does not have jurisdiction over tax legislation, we know of your support of state regulation of insurance and your concern over the solvency of all types of financial institutions and insurance companies. Therefore, we would be remiss if we did not mention our very serious concern over the Treasury II tax proposals section covering property and casualty insurance companies. We believe the entire section would be harmful to the basic operation of P/C insurance, and the Qualified Reserve Account would do serious damage to state regulation of insurance for

solvency. In view of our concern over solvency and state insurance regulation and the fact that some members of this Committee are also on the Finance Committee, we would appreciate your including in the hearing record copies of our statement submitted to the House Banking, Finance and Urban Affairs Subcommittee on Economic Stabilization and the NAIC resolution.

Tying of the Insurance Product

Explicit anti-tying statutes have been on the books for years but have signally failed even against blatant tying. FTC and Federal Reserve Board studies have verified that the Sherman Act and the Bank Holding Company Act have not curbed this abuse. The passive tie-in frustrates all attempts at legislative drafting. As long as a single bank organization is permitted tomarket connective insurance products, the evils of the passive tie-in will persist. Few borrowers, sophisticated or not, can miss the implication that purchasing insurance from a bank will help him or her obtain a loan. That is a form of coercion too subtle to prove or prevent and one that the bank cannot avoid exerting. The tie-in issue has eluded all attempts at resolution and it is a particularly important problem in the commercial banking/insurance area. A suggestion that might be developed is that banks be subject to a "cooling off" period from selling or underwriting insurance whenever it makes a loan on any commercial, home or chattel coverages.

Economic Concentration

As competition heats up in the financial services arena, banks will enter the fray with unfair advantages due to their legal monopoly over demand deposit accounts. The special power to "create" and "destroy" demand deposits has already allowed a relatively small number of commercial banks to accumulate assets that dwarf the resources of other financial institutions. It is unfair to insurers to permit banks to acquire resources under a unique franchise and then use them against competitors that have not enjoyed the banking privilege.

CONCLUSION

Mr. Chairman, Confucious wished that we may live in interesting times. These are very interesting times, but they are also very confusing and unsettling. The NAII urges Congress to act and we are most willing to cooperate with your staff and others in the financial services industry to reach a final resolution to these issues.

The CHAIRMAN. Thank you, Mr. Crosby.

Mr. Carter, you have brought up some arguments that I've heard many times about granting banks additional powers and I suppose I'm rather disappointed to hear those from you, with the position you hold of great responsibility and your stature, and my personal respect for you. It's easy to make charges.

Can you substantiate any specifics where any banks of the 79 that failed last year or the troubled this year have anything to do with deregulation, or anything whatsoever to do with what was done in Garn-St Germain or the Financial Institutions Deregulation Act of 1980?

Mr. CARTER. A three-part answer, Senator. I don't believe that the deregulation—at least I know of no instance in that period of time where deregulation was responsible for the failure of a bank.

CAUSES OF BANK FAILURE

I think there are many different reasons for those failures, probably poor management being at the forefront of the list.

Second——

The CHAIRMAN. Well, aren't most of them, almost without exception, either fraud, like in the Jake Butcher situation in Tennessee, or the case of simply very bad judgment in making the normal loans that banks have always made, making poor risk assessments?

Mr. CARTER. Energy loans to an excess and so on, yes.

Second, anybody who's looking for deregulation these days I think is making an awful mistake, no matter what capacity he's in. We're looking for reregulation. And the play on words is somewhat trite, but it's a very important distinction.

Third, I keep getting cast in front of you—and it's undoubtedly my own fault—as not wanting the banks to go into the life insurance business probably for selfish reasons, for protection of turf and so on. I hope I can shed that image.

We believe it is fundamentally unethical for banks to be in the life insurance business or for life insurance companies to be in the banking business and believe the definition of each of those businesses should be drawn in a very narrow form.

We should not be in the banking business and the banks should not be in our business.

I also seem to be cast in a role of trying to keep the banks out of the life insurance business because I feel they will eat us up competitively. That is not the case at all. Whenever we have gone up against banks, the life insurance business—as in my own State of New York—does very nicely against the savings banks. We have no problems at all.

Many companies that have gone into the life insurance business in recent years—American Can probably being the largest example—they outproduced the largest life insurance company sales of individual life last year by a considerable margin. You never heard complaints from us about American Can or about a lot of other companies.

It's the fundamental difference in those two financial services provided, one by life insurance companies and one by banks, that should be kept separate in any bill at any time in the future.

The CHAIRMAN. Well, I don't disagree. I happen to be the author of title VI of Garn-St Germain and I happen to have been an insurance agent that used to talk a great deal about tying sales and testified before the Utah legislature before I got involved in politics myself. That wasn't the issue I was addressing.

Getting back to a more fundamental issue of my disappointment with your general testimony, which if I didn't know you and talked to you personally before would indicate to me that somehow all these banks that are failing are due to deregulation and that this rush of deregulation should be stopped.

I think deregulation is occurring in the financial marketplace not because of legislation. In Garn-St Germain, the deregulation was essentially to remove interest rate ceilings. That was about the extent of it, to remove interest rate ceilings, because there was a $200 billion outflow of money out of traditional depository institutions due to raids by Merrill Lynch and securities dealers who were denying they were in the banking business.

I just want to dispell that and your answers were very clear that you agreed with me that it was due to other causes and not deregulation. That's why I asked that question because your testimony would seem to me to indicate otherwise.

That is a myth that disturbs me that is constantly perpetrated by those who oppose deregulation. Now that is a red herring. That is a real red herring because you can look at the record of those bank failures and you will find they are not failing because we removed the interest rate ceilings which were started in 1980 on a phased-out basis. All we did was speed it up somewhat. There were no gigantic new powers granted in Garn-St Germain.

Sometimes when I hear and read about what my bill did it's certainly a different bill that I passed compared to the facts. So I just wanted to establish that first. Yes, we've got problems in the financial services industry with depository institutions, but not because we removed interest rate ceilings. And I would hate to see what the condition would be if we had not removed those interest rate ceilings and Merrill Lynch was still paying whatever the market rate was. The thrift industry, with 5.25 or 5.5 interest rate ceilings, would have been gone. There wouldn't be one any more.

Mr. CARTER. Senator, the ACLI is in complete concurrence with you and page 4 of my testimony that I submitted clearly states that.

The CHAIRMAN. Let me address one other issue that you are well aware of and the witnesses who follow you are very well aware of, an issue that I have—how do I phrase it— been more upset with, more disappointed in than any since I've been in the Congress, and more angry about because I made my living in your industry for 10 years. I suppose that's the reason that I selected that industry because I didn't want to work for somebody else. I wanted to be my own boss. I was very conservative, very independent, and wanted to work on a commission basis because then I knew I got paid for what I did, and that is certainly true in the insurance business. If you don't produce, you don't make a living. It's just that simple.

I used to hate 3-day holidays because I couldn't work and I had a very small agency at one point where I had to make $2,500 a month and if I made $2,501 I got to keep $1. Maybe that's why I

feel so strongly about it and why I've been upset with some of the testimony over the last couple of years, especially when I share the worries about tying sales.

FEW FEDERAL REGULATIONS

When I offered title VI, I closed the South Dakota loophole in S. 2851, totally agreeing that no State should be allowed to make decisions on exporting services across their boundaries. Also, being one who always defended McCarran-Ferguson and will continue to do so, I don't want the Fed—yes, you have other regulations, but in the daily conduct of your business, relatively speaking, you're virtually federally unregulated compared to financial institutions. I'm sure there are others that you are subjected to.

And as frustrating as that may be with different filings at times in 50 different States and all the work that causes you, you will put up with that and I will put up with that for the absence of getting the Federal Government involved and the FTC and all the long tentacles of Washington, DC.

So it's puzzling to me that we have gotten into such a rather acrimonious debate when I'm the one who's been on your side, that's kept legislation alive in the form of title VI and so on. But I have a more fundamental feeling and I must very seriously disagree with you that this is a red herring when we talk about States rights.

Because I represent a small State and there are a lot of things that I disagree with that the Utah Legislature does, but I will defend their right to make those decisions within the boundaries of my State. So I still feel very strongly that we closed the South Dakota loophole adequately and completely. It was discussed at great length so there was no opportunity for exportation of insurance services across State boundaries.

On the other hand, regardless of the ownership, as long as they are prohibited from crossing State lines and exporting services, as South Dakota tried to do with Citicorp, it seems to me that the Utah Legislature or the South Dakota Legislature or any other State ought to have the right to decide solely within the boundaries of those States what State-chartered institutions do, without regard to whether they are owned by a bank holding company or not, as long as they can't sell that product.

And I've talked with a lot of insurance agents in my own State and I've asked them a simple question: "Are you willing to go do battle with the State legislature in Utah if they consider granting or decide to grant insurance to State-chartered institutions?" And they say, "Of course."

Most of them don't understand the Dodd amendment. They don't understand that it goes one step further. I even tried one more modification on the floor which was not acceptable because of the greed of the insurance industry of wanting to run to Washington and get it cut off so that they didn't have to deal with them. That may not be your intent, but I think this all evolved when the New York State report to Governor Cuomo was recommending that this happen. So rather than go fight the New York State Legislature, they said, "Hey, let's run to Washington. Let's get an amendment

down there and we'll clip New York off and get all the rest of them all at once."

That may not be your intent. It's certainly not the intent of my insurance companies in Utah. But I believe that's the genesis of why this occurred. It was to get New York. That's the biggie. Let's keep New York and don't do it in the New York Legislature.

MORE CENTRALIZED POWER IN WASHINGTON

But as I have seen as a former mayor, as I have seen more and more power centralized in Washington, and as I saw my ability to be a mayor taken away and really be the local manager for the Federal Government with all the strings attached and so on, I feel so strongly about States rights and will continue to do so. I'm very sorry that insurance companies and the insurance agents have chosen to go one step further and not have the guts or the courage to argue before State legislatures in 50 States. Again, I repeat and I will repeat it over again—State-chartered institutions should be solely operated within the boundaries of their State. It just doesn't seem right for those who confess to be conservative—I'm not talking about Republicans, Democrats or anything like that—but the independents, the type I described as why I went into the insurance business that are running to the Federal Government to solve the problem with their State legislatures. Again, I agree, and I would be opposed to granting those powers and my record is clear on that.

We tried one more compromise that was even rejected and that was to say,

> All right. We'll split it. We'll say if it's a holding company that is only within the State and the State-chartered banks under that, we will exclude the out-of-State holding company even from granting those powers inside a State even though they can't export it.

Even that was turned down when we were going to limit it to bank holding companies that operated only within one's State.

So this will save me saying it when the next group of witnesses gets up here, but that is a principle that I don't intend to give up on. There are enough votes to keep it. I don't think you have to worry about the Dodd amendment staying in. It's going to be a fact of life. There aren't enough votes on this committee, I can't convince my colleagues here, I can't on the floor and I can't in the House of Representatives. So you're going to win. The insurance industry is going to win the battle, but with a great deal of disrespect from me for taking it one step further and violating such a very basic principle.

The South Dakota loophole could be closed if we would just leave it. Then they could go fight the individual legislatures.

Mr. CARTER. Two points, Senator. One, I used the term "red herring." In reading it over here, it could communicate the way I think you took it. It was not meant to communicate that way.

It was meant to be critical of the people bringing the point up, not critical of the point itself. I apologize for that.

On the other item, I think some of us would be more than willing to go back to the ACLI and debate that point. I suspect it is

subtle enough in that circle to have maybe somewhat been unattended to and I would be more than happy to do that.

The CHAIRMAN. Well, I would appreciate that. I really think it's something that ought to be reconsidered, although I don't expect it to be, simply because you've got the votes to win.

Mr. CARTER. That's not the right way for us to operate, though.

The CHAIRMAN. But I think it's a decision which you will regret—not soon, but—I don't mean from me.

Mr. CARTER. No.

The CHAIRMAN. I don't mean from me because here we are and we've had a battle going on for a couple of years over an issue that we agree on. It's a matter of how you handle it. But in the nature and involvement of Federal Government involvement in the private sector, sure as the day will dawn some day, somebody is going to try—it may be 5 years down the road, may be 10, may be 15—but some things we're doing in the Federal Government today I would not have believed 15 or 20 years ago that they would ever happen. They wear you down a piece at a time.

What I'm saying is some day there will be an attack on McCarran-Ferguson and you will be faced with what you're trying to impose on the banks now. And you'll look back and say, "Yes, we won a battle. We kept the Dodd amendment in there, but look what's happening to McCarran-Ferguson and, boy, does the FTC want to get their hands on us."

So I think it's a long-term mistake. I really do. And that is no threat from me. You will never, ever find me— I will stick to my basic principles—ever favoring or voting for changes in McCarran-Ferguson. So that's not a threat. It's just what I think will happen that we have seen happen so many times with Federal Government involvement.

Senator Riegle.

Senator RIEGLE. Mr. Chairman, I have some questions that I'd like to ask, a couple which I will address in person and others that I'd like to have you answer for the record, and I also have some questions I would like to have the next panel answer for the record. As you know, we have a special briefing underway on the hostage problem in Lebanon where we otherwise should be at this time and I feel the need to go there shortly, but I'll enjoy hearing your comments and listening to the exchange.

The chairman and I don't exactly see this the same way and I've listened patiently to his view and now I want to state mine. I don't suggest by that that we are on a collision course necessarily, but everybody sees this differently and from a different vantage point.

One thing I am convinced of, though, is that whoever is chairman of the committee is not going to be chairman of the committee indefinitely, whether it's this chairman or Bill Proxmire who's chairman or myself if I become chairman, because time rolls on. We all leave at some point for one reason or another.

CONCERN FOR DIRECTION OF EVENTS

My concern is not with any pledge that any of us can give you because we can't give you any pledge that lasts any longer than we're here and that may terminate an hour from now, God forbid,

by some means. So I'm concerned about the legislative direction of events because I've listened to Don Regan come before this committee and he's still a very important person in this administration, and last week Secretary Baker came before this committee, and they have in mind, as I heard them, doing things that the chairman may not have in mind. But I don't underestimate the power of the train of events getting started to be greater than even the chairman, for whom I have great regard, being able to deflect, or myself, or anybody else.

So I don't think it's a question of how we feel so much personally in terms of the kinds of assurance that we try to give because I think that's all very temporary and all sort of gossamer.

I am much more concerned about whether we are blocking ourselves on a track that takes us into the future with a set of implications and ramifications that are very disturbing to me, because what I hear and what I've heard before is one-stop shopping where all the boundary lines come down, where it's easy to compare price and other things and basically get lost in that kind of discussion.

Clearly, there's an awful lot of momentum behind that concept in this administration. It's no secret. So I don't diminish in any way the powers of the chairman here because he's a very strong and active chairman and he has strong views and he makes those views felt and will as long as he's here, and more power to him. I mean that composes in the task of being the chairman, but I think it would be a mistake for you ever to take any assurances that anybody around this table give you as to what the future is going to look like because sooner or later you will be back in here and you will see all new faces here because that's the nature of the situation.

So I think you've got to look a lot deeper in terms of the trend lines that we're setting in motion. So I want to pose three quick questions to you. I'd like each of you to respond.

Secretary Baker proposed that the Bank Holding Company Act be amended when he testified here to give bank holding companies the authority to engage in activities "of a financial nature"—that's the exact phraseology.

I'm just wondering what you think the result of such an amendment as that would be and would you support such an amendment as that?

Mr. CARTER. A quick answer, no.

Senator RIEGLE. Mr. Crosby, I assume you're a no on that as well?

Mr. CROSBY. Well, I'm not sure how Secretary Baker would define "financial nature." If you can elaborate on that for me, perhaps I could respond.

Senator RIEGLE. That's precisely the dilemma. I mean, it seems to me that if there were a desire to have a nice, clear, narrow, precise definition, we would have one. We wouldn't be dealing with an ambiguous term that's designed I think to be beyond defining and in a sense to sort of open things up in a big way.

The FDIC recently proposed regulations that would permit FDIC-insured banks to sell various kinds of insurance. It would also permit banks to underwrite life insurance directly and to underwrite property and casualty insurance through subsidiaries. I know

you have touched on this but I want your reaction here again in the chain of the questions that I'm asking.

So what would be your reaction to that FDIC proposal?

Mr. CARTER. We would oppose it.

Senator RIEGLE. And why?

Mr. CARTER. Let me simplify the question down to just banks and life insurance. I'm repeating myself here. We don't oppose for competitive reasons or turf reasons the combination of those two services. We oppose them for ethical reasons.

We do not believe that either such institution ought to be in the other business. Life insurance companies should not be in the banking business. They are two very different services. The nature of the matchup of assets and liabilities in each case is very, very different. We are in the business of making 40-, 50-, 60-, 80-year long promises. Banks are not in that business. We are not in the business of creating sources of credit that are appropriate for banks to create and should not be in the banking business.

So that fundamental answer drives all the rest of the answers to your questions.

Senator RIEGLE. Mr. Crosby.

Mr. CROSBY. Speaking for our property and casualty insurers, the FDIC proposal would allow insurance underwriting through separate subsidiaries. As I said in my testimony, so long as it was conducted through a separate corporate affiliate and subject to State regulation, we would have no inherent objections to the FDIC's recommendation.

The property and casualty companies that we represent welcome competition from the banking industry. In fact, Citibank right now is trying to acquire two of our member companies in the State of Wisconsin. So this is nothing new to us.

We do share some concerns with the ACLI as far as how the FDIC proposal would affect life insurers, but that is not our cup of tea.

Mr. CARTER. Senator, we've made a submission to the FDIC and if you would like a copy of that we could get it for you.

Senator RIEGLE. That would be helpful.

Mr. CROSBY. Likewise in our case.

[Response to Senator Riegle's request follows:]

JUL 22 1985

July 17, 1985

The Honorable Donald W. Riegle
105 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Senator Riegle:

As I indicated to you at the June 19 hearing, the life insurance industry is strongly opposed to the FDIC's proposed rulemaking regarding the involvement of insured banks in real estate and insurance activities. Despite the FDIC's protestations to the contrary, this action constitutes an open invitation to the states to authorize their depository institutions to enter into these very activities. More importantly, the proposals themselves are fundamentally flawed and, if adopted, would give rise to serious concerns over bank safety and soundness.

I am providing you with a copy of the submission which the American Council of Life Insurance made to the FDIC when these rules were initially proposed earlier this year. The FDIC recently reproposed the rules in a form which, unfortunately, would exacerbate the problem of ensuring adequate safety and soundness. The most glaring example of this is in the area of life insurance underwriting, where the FDIC would now permit insured banks to engage in this activity directly rather than through separate subsidiaries. It is difficult enough to attempt to isolate banking and nonbanking operations through the use of a separate subsidiary; however, permitting these operations to be comingled within the same entity makes isolation impossible and would seriously jeopardize the integrity of the banking system.

I hope this material is responsive to the question you asked.

Sincerely,

Att.

cc: Chairman Jake Garn
Richard S. Schweiker-ACLI

American Council of Life Insurance

1850 K Street, N.W.,
Washington, D.C. 20006
(202) 862-4000

January 31, 1985

Mr. Hoyle L. Robinson
Executive Secretary
Federal Deposit Insurance
Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429

Dear Mr. Robinson:

The American Council of Life Insurance ("Council") appreciates the opportunity to comment on the FDIC's Notice of Proposed Rulemaking ("Notice") on the subject of "Powers Inconsistent with the Purposes of Federal Deposit Insurance Law" as published in the Federal Register on December 13, 1984. The Council is the principal trade association for life insurance companies and has a membership of 615 stock and mutual companies. These companies in the aggregate account for 93 percent of the assets of U.S. life insurers and 95 percent of the assets of insured domestic pension plans.

The financial services industry is presently undergoing a period of significant change. Change of this nature requires that systems of regulation be reviewed periodically in order to determine whether they must be revised so as to keep pace with evolving regulatory needs. To the extent that the FDIC's proposed rules are advanced in response to identified and valid regulatory needs, its action is generally appropriate. However, where no valid regulatory needs can be demonstrated, rulemaking may not constitute a reasonable exercise of administrative power, particularly if it places the agency in the posture of creating rather than implementing national banking policy, a function which is appropriately left to Congress or, in limited instances, state legislatures.

Our comments in this submission are directed to those aspects of the Notice relevant to the insurance activities of banks. We do not address the appropriateness of the proposed rules as they might affect other activities. As to insurance, we do not believe that the FDIC has established that any regulatory need exists which warrants the rules it is proposing, and the following general policy considerations support this

conclusion. In addition, we oppose the adoption of the proposed rules on bank insurance activity based upon a number of other considerations which this letter discusses.

GENERAL POLICY CONSIDERATIONS

Proposed Rules Based on Faulty Premise. The FDIC has premised these proposed rules on the notion that such action is warranted by recent changes in state laws authorizing banks to conduct commercial activities such as insurance underwriting. As to insurance, this premise is not supportable.

Only one state (South Dakota) has recently enacted any law granting banks explicit authority to underwrite insurance, and, as yet, not a single South Dakota bank has undertaken to exercise this new insurance power. While several bank holding companies have filed applications with the Federal Reserve to acquire South Dakota banks as a means of expanding their insurance authority beyond that permitted under the Bank Holding Company Act, approval has not been granted. Significantly, on January 6, 1984 the Fed issued a press release stating that it had reached a "tentative decision" that it could not approve the acquisitions "based on present law and the intent of Congress." The validity of the state enabling legislation loophole will likely be ruled upon shortly by the Fed and ultimately resolved by the courts. In the event this loophole is found to be illusory, the FDIC's proposal as it pertains to insurance would, for most banks, be nullified. Prompting states to enact laws or institutions to materially change their position in reliance on an interpretation of the law that is potentially erroneous will likely prove counterproductive.

The Notice also refers to the proliferation of nonbank banks as contributing to the need for the proposed regulations. The existence of these institutions cannot substantiate the need for these proposed regulations when, in fact, their continued existence is seriously in doubt because of challenges in the courts and the avowed intent of the chairmen of both Congressional banking committees to eliminate nonbank banks in the 99th Congress.

Inappropriate Exercise of Regulatory Power. It is evident that any recent deterioration of the barriers between banking and commerce has occurred primarily through resort to loopholes in existing statutes -- a process often encouraged by federal bank regulators -- rather than by changes in policy on the part of state legislatures. Thus, far from being a response to the regulatory needs of the financial services marketplace as it is today, the proposal is simply a reflection of the FDIC's preferences regarding the structure of the financial service marketplace of tomorrow, and, as such, is not a proper exercise of rulemaking authority. The proper role of the FDIC is to implement existing policy, not to attempt the establishment of new policy. To the extent the latter objective is reflected in this proposal, we believe the FDIC has exceeded its statutory authority.

Statements throughout the Notice evince the FDIC's policy-making intent, but none so clearly as that on page 4 where it is stated "The FDIC strongly supports expansion of bank powers that would allow banks to develop new sources of income to offset the costs of liability deregulation."

The message of the FDIC to the states is clear: "We want you to expand the powers of your state banks, and here is how to do it." Encouraging the assumption of substantial and unfamiliar risks by state banks is an inappropriate action for the agency that is charged with ensuring the soundness of the nation's banking system.

As with any other business enterprise, the most reliable way to ensure safety and soundness is to make the enterprise self-sufficient. This applies with more than usual force to banking, where the consequences of the deterioration of safety and soundness are profound. There is no indication that the proposed nonbanking activities have been evaluated in any definitive way to determine if, in fact, they will generate income for the bank, or indeed will require infusions of capital from the bank or the bank holding company parent. The FDIC has apparently not reviewed the cyclicity of the various proposed businesses. This cyclicity may have a dramatic effect on profitability and the degree of risk to which a bank is exposed, as well as the public's perception of the stability of the bank and its related enterprises.

Compounding of Risk. The Notice indicates that the FDIC was not convinced by suggestions from commentators on the Advance Notice that nonbanking activities such as insurance underwriting are necessarily more risky than traditional banking activities. If the FDIC is predicating its present proposal even in small part on this notion of comparative risk, it has missed perhaps the most important consideration in assessing the propriety of combining banking with businesses such as insurance. It is irrelevant to debate whether insurance underwriting is more risky than traditional banking operations. The important point is that both businesses have a high degree of inherent risk.[1/] When the discrete risks of each business are aggregated, however, the attendant risk for the overall enterprise is necessarily compounded. It is this compounding or pyramiding of risk which poses the greatest threat to the safety and soundness not only of the banking system but also of insurers and other financial intermediaries as well.

1/ One particularly puzzling statement in the Notice appears on page 18 where the FDIC states, albeit "preliminarily," that insurance underwriting "... is not inherently unsafe and unsound in all instances." If underwriting is unsafe and unsound in most instances as this statement implies, we cannot understand why the FDIC would encourage banks to enter the business, indirectly or otherwise.

The issue of aggregating risks takes on added significance when viewed against the backdrop of last year's record 79 bank failures. When one considers the magnitude of a failure such as Continental Illinois, it is easy to understand why many believe the nation's bank regulatory system is not capable of dealing effectively with more complex and risky corporate organizations.

OTHER CONSIDERATIONS

Apart from our general policy concerns relating to the Notice, there are a number of other specific issues which the Council believes argue against the rules' adoption.

Inability To Insulate Subsidiaries. The dangers to institutional safety and soundness that result from combining the risks of disparate businesses are not appreciably lessened by using subsidiaries to house additional activities. Federal Reserve officials have long recognized that subsidiary arrangements "... are not likely to produce a situation in which the bank is immune from the problems, risks or losses that might develop in such subsidiaries. In short, such a structure is neither a substitute for prudent management nor a fail-safe device for containing risk." 2/ The FDIC concedes the difficulty of effectively preventing the liabilities of a subsidiary from inuring to the parent and proposes a number of cosmetic measures in an effort to achieve some degree of legal separation between the two.

However, the FDIC's recognition of the need to advertise the relationship between the bank and the nonbanking business belies the assumption that one financially diseased member could ever be amputated without critical impact on the entire organism. Prohibiting a common name and having office space "clearly demarcated" with a separate entrance "where structurally feasible" would be almost totally ineffective in preventing a perception of affiliation in the mind of the public, especially when the bank would, in the FDIC's view, want to affirmatively promote that perception.

Recent experience in the insurance industry involving the problems of the Baldwin-United and Charter organizations indicate that the public draws its own conclusions about the solvency and survivability of parent and subsidiary organizations notwithstanding the legal relationships and public declarations of the affected entities. We can say with some assurance that if Continental Illinois had owned a healthy and profitable insurance subsidiary with a completely different name, that subsidiary would have experienced a crippling and very likely fatal number of cash surrenders on its policies as the result of adverse publicity about its parent. The public's perception is very often that the failure of a

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2/ E. Gerald Corrigan, 1982 Annual Report of the Minneapolis Federal Reserve Bank, p.18.

part of an enterprise is the failure of the whole, and that fact should, but apparently doesn't, give pause to the FDIC. While legislators and regulators can fill volumes with laws and regulations that attempt to isolate parents from the liabilities of their subsidiaries, they cannot ever legislate public perception of a situation. And, in the final analysis, the public's perception is often the most critical element in determining whether an institution endures or fails at a time of financial crisis.

Failure to Consider Competitive Implications on Nonbanking Businesses. Perhaps the most distressing flaw in the proposed rules is the inherent competitive inequity that would result by permitting a bank to conduct its nonbanking activities through a downstream subsidiary.

No one disputes that banks are unique among financial institutions, in large measure because of their access to the Fed as lender of last resort and because a substantial portion of their deposits are protected by federal deposit insurance. It is this very uniqueness that enables banks to raise money in the capital markets at a lower cost than other borrowers. The federal "safety net" permits banks to pay lower returns on borrowed funds and serves to overcome investor or depositor reluctance to place funds with banks.

Permitting banks to utilize these lower cost funds to capitalize subsidiary nonbanking businesses is patently discriminatory and unfair to all nonbanking competitors engaged in those businesses. Lest the FDIC forget, it is these very considerations that have led the Administration to require in its proposed banking deregulation legislation that all expanded insurance and real estate activities be conducted upstream of a bank. In recent testimony before the Senate Banking Committee, Treasury Secretary Regan stated:

> The Administration, in addition, does not believe that non-depository institution activities should be conducted through a subsidiary or service corporation in which a bank or thrift has a direct equity investment. Again, the investment would be at risk if the subsidiary's activities were to falter, and the funds for the investment would be raised with Federal assistance not available to non-depository institution competitors and at a cost advantage to the bank or thrift. In addition to permitting equivalent regulation of functionally equivalent activities, the adoption of the holding company approach as the underlying principle of depository institution deregulation would remove many of the inconsistencies and anomalies that currently confuse the issue of bank deregulation.3/

3/ Hearings on S.2181 before the Senate Committee on Banking, Housing and Urban Affairs, 98th Congress, 1st Sess., pt. 1, at 217 (1984).

Given the general opposition of the life insurance industry to the further deregulation of the banking industry, we do not endorse the Administration's legislative proposal. 4/ However, the Administration's proposal at least recognizes that deregulation of the banking industry will have profound effects on other financial intermediaries and has not been advanced with an attitude of total disregard for the integrity of those other institutions. Simply stated, deregulation cannot be approached from a parochial standpoint that reflects only the perspective of one segment of the financial services industry. In this sense, the FDIC's proposed rules are ill-conceived and should not be adopted until they address on an integrated basis the whole question of competitive equity.

Appropriateness of Percentage Limitations. The proposed rules provide that any bank establishing one or more insurance subsidiaries cannot have more than 20% of its primary capital invested in such subsidiaries. Similar limitations are imposed on investments in real estate subsidiaries, and an overall limitation of 40% of primary capital is imposed on aggregate investments in all insurance and real estate subsidiaries. The stated purpose of these limitations is to protect the bank's capital position from the activities of its subsidiaries and to ensure that the bank's business is directed primarily toward the traditional business of banking. We believe that, as presently drafted, the limitations fail to effectuate either of these objectives.

As we have already pointed out, the use of a separate subsidiary does not serve as a truly effective means of isolating banks from liabilities incurred by their nonbanking subsidiaries--regardless of the percentage limitations imposed. Indeed, the FDIC concedes this very point in several sections of its release. 5/

From a more technical standpoint, the percentage limitations are suspect in several key respects. For example, we are at a total loss to understand why the FDIC has chosen to ignore for purposes of computing the

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4/ Beyond our broad policy concerns with the Administration's proposed legislation, we have serious technical problems with a holding company approach to deregulation as, for example, the inability of entities organized in mutual form to compete with their stock counterparts.

5/ For example, in discussing provisions intended to establish corporate separateness on pages 18-22, the FDIC explicitly acknowledges that its rules can at best only diminish the likelihood that a parent corporation will experience a drain on its capital as a result of subsidiary operations. Taken as a whole, this discussion does little to inspire confidence that the FDIC's proposed rules would in fact ensure safety and soundness. Rather, it suggests that the FDIC is merely endeavoring to lessen the increased risk that most certainly will be incurred by banks engaging in these activities.

percentage limitations the assets that a bank devotes to the direct conduct of certain activities, most notably insurance agency and credit insurance underwriting activities. While it is arguable that insurance agency activities are inherently less of a threat to capital, we nevertheless believe that there is no justification for their not being included in the 20% and 40% limitations, particularly if those limitations are, as the FDIC suggests, intended to ensure "... that an insured bank's business is primarily directed towards the traditional areas of banking." 6/

The well-publicized problems now facing broker/dealers involved with the sale of single premium deferred annuities (the very type of product that many bankers have suggested they would like to sell), illustrate graphically the prospects for tremendous financial liability that non-insurance entities may face as a result of mere insurance agency activity. Potential liability of this magnitude directly contradicts the basic distinction between bank conduct of insurance agency and insurance underwriting which the FDIC's proposal attempts to draw and, in any event, undermines the FDIC's position that insurance agency activities conducted directly within a bank need not be considered when interpreting the percentage limitations. Similarly, there is no justification for distinguishing between types of insurance underwriting.

The percentage limitations also fail to take cognizance of certain indirect transactions, such as transactions between affiliates. 7/ As we understand the proposed rules, a bank could devote up to 20% of its primary capital to an insurance subsidiary and yet exceed that cap by making a loan to its real estate subsidiary which, in turn could make a loan directly to the insurance affiliate. Transactions of this nature should, of course, be prohibited.

It also appears that the bank's exposure to loss could be increased beyond the percentage limitations as the result of affiliate transactions that this rule would not prohibit. Such transactions include bank purchase or refinancing of problem loans insured by a mortgage insurance subsidiary, or forms of self-insurance. We believe that the FDIC should bar transactions of this nature if it truly intends to take appropriate steps to protect bank safety and soundness.

Finally, the proposal makes no mention of the situation in which a bank with ongoing insurance or real estate subsidiary operations encounters difficulties which cause its primary capital to become significantly impaired. Is the bank expected to retain its insurance or real estate operations until the FDIC is ultimately forced to step in and nationalize

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6/ Release at p.24.

7/ Ibid.

the entire enterprise or otherwise deal with the situation? We believe that current solvency problems within the banking industry and the additional risks associated with the activities that the FDIC is encouraging banks to undertake demand that this issue be addressed in any final rules.

Location of Certain Nonbanking Activities. Related to the above discussion is the question of whether a bank that establishes an insurance subsidiary should be required to transfer to that subsidiary all of the insurance operations that it is conducting directly (e.g., any credit insurance underwriting or insurance agency activity). We believe that such a transfer would be appropriate for several reasons.

In the Notice the FDIC discusses its concern with certain conflicts of interest, most notably, tying arrangements. 8/ There can be little doubt that it would be easier to police abuses of this sort if similar nonbanking activities were conducted in a single entity separate and distinct from the bank. We hasten to point out that many of the concerns mentioned by the FDIC as justification for the use of a separate subsidiary for "risky" nonbanking activities involve potential conflicts of interest. Unfortunately the potential for conflicts of interest does not necessarily have any relation to the riskiness of the business being conducted. Consequently, absent overriding considerations, regulation should not be determined on the basis of relative risk. In this area, uniformity of regulation would seem to argue for all insurance activities to be conducted in the same entity.

In addition, placement of all insurance activities in the insurance subsidiary would partially ameliorate the problems that insurance and bank regulators will undoubtedly confront in dealing with integrated financial institutions.

For these reasons, we believe that any bank required by the instant rules to establish an insurance subsidiary should be required within a reasonable period of time to transfer to that subsidiary any other insurance operations that it is conducting directly. We believe that it would be reasonable to require that such a transfer be made within a two year period, as that time frame is consistent with the compliance provisions of Section 332.9(b) of the proposed rules.

Regulatory Conflict. A comment on pages 16 and 17 of the release

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8/ In its discussion of tie-ins, the FDIC questions whether it should adopt an affirmative requirement that bank customers receive a disclosure statement addressing this problem. In view of documented cases of bank tie-ins and pending litigation on the point, the answer seems obvious. But, for the record, yes, we believe such disclosure is essential.

suggests that by conducting nonbanking activities in a subsidiary (as opposed to directly within the bank) regulatory overlap and conflict can be avoided. This conclusion is not supported by any evidence produced in the Notice and, in fact, is contradicted by the FDIC's own statements. The FDIC states that it will, of course, retain the authority to examine the affairs of any affiliate or subsidiary of an insured bank. That would mean that an insurance subsidiary would be subject to dual regulation by state insurance officials and the FDIC. 9/ Given the differences between these regulators in regulatory objectives and constituencies to be protected, regulatory conflict is certain and should be accepted as an inevitable by-product of an integrated financial services industry.

CONCLUSION

The Council fundamentally disagrees with the FDIC on the propriety of integrating the businesses of banking and insurance. However, that is not the issue that should dictate whether or not these proposed rules are adopted. Rather, the issue is whether the FDIC has demonstrated that changes in the financial services industry have given rise to regulatory needs that must be addressed. As to insurance, no such demonstration has been made, and, that being so, if the FDIC were to move forward and adopt these rules, it would be exceeding its statutory authority.

Matters of national banking policy must be left to legislative bodies and not to regulatory bodies. While this fact may prove frustrating to pro-deregulation regulatory agencies that would like to see sweeping changes implemented promptly, it is nonetheless the only way in which sound, broad-based policy can be developed.

Inasmuch as the proposed rules relating to insurance are based on unsupportable presumptions and have other shortcomings that would prove extremely injurious to many financial institutions, it is the Council's view that these rules should be withdrawn.

Sincerely yours,

Allen R. Caskie
Associate General Counsel

Gary E. Hughes
Chief Counsel, Securities

9/ For the same reason that the FDIC asserts its authority to play a regulatory role in the affairs of an insurance subsidiary, we presume the NAIC would demand the authority to look into the affairs of the banking "piece" of such an enterprise, thus subjecting the depository institution with a form of dual regulation as well.

National Association of Independent Insurers

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JOHN B. CROSBY
VICE PRESIDENT & GENERAL COUNSEL

July 18, 1985

Hoyle L. Robinson
Executive Secretary
Room 6108, Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

RE: Proposed Amendments to Part 332 FDIC Regulations
FR Volume 50 No. 110

Dear Mr. Robinson:

This is our third submission to the FDIC urging measured restraint on its part in allowing banks under its guardianship to underwrite property and casualty insurance. Notwithstanding the highly risky nature of this enterprise, the FDIC has chosen to ignore traditional wisdom and, instead, to acquiesce to banking interests who, in our opinion, are a less than credible source for the risks and realities of casualty insurance underwriting. The NAII welcomes bank entry into the competitive insurance industry (with equal freedom for insurers to enter into banking), but certainly not at the expense of state regulation of the business of insurance or of the consuming public.

The NAII is a voluntary national property and casualty trade association of approximately 500 member companies. Our members range from small one-state writers to the very largest national writers. They are stock, mutual and reciprocal companies and they use a variety of systems to merchandise the insurance product from agency to direct writer and direct mail. Our members underwrite approximately 32% of the insured automobiles and 24% of the insured homes in our nation.

The Risk Factor in Property & Casualty Underwriting

The NAII was not one of those that were opposed to any bank entry into any aspect of the insurance industry. But along with other insurance interests, we have grave concerns about parity and implicit tying. We have previously warned of the risk involved in property and casualty underwriting as it bears directly on FDIC's policy for "soundness of banking" and "promoting stabilization and confidence in (the) nation's banking system." The FDIC, however, accepted the arguments of a few money-center banks that "insurance

activities have not created any safety or soundness problems" and that "insurance powers have generally not been abused". How can any bank assess safety ans soundness when no bank, to our knowledge, has been involved directly or through a subsidiary or affiliate in property and casualty underwriting? As for the absence of abuse, the banks' claim flies in the face of a myriad of documented instances of tying by banks in the sale of insurance and the extension of loans. FTC, as well as Federal Reserve Board studies, have proved this.

If the FDIC is determined to ignore the risks and allow banks to underwrite property and casualty insurance, then it should require that insurance may not be written through a bank's subsidiary, but only through a separate corporate affiliate within the bank holding company structure. Requiring an affiliate would bring into play the protections and restrictions on transactions built into the amendments to the Federal Reserve Act. State insurance regulators could identify and monitor an affiliate within the bank holding company structure more easily than a subsidiary of a bank.

A bank holding company should be prohibited from purchasing an existing insurer and should be required instead to form an insurance affiliate de novo. This requirement would have the advantage of bringing fresh capital into the insurance business. Our industry is under a severe and intensifying strain to increase its capacity to underwrite the risks that will be presented to us in the future. To purchase an existing insurer does nothing to add new resources to the insurance business, but merely depletes capital in some other sector of the economy.

Regulation

In the revised underwriting provisions of the proposed regulation, the FDIC will permit a bank to conduct life insurance underwriting through a department of a bank provided certain enumerated safeguards are established by the federal statute or regulation authorizing the bank to underwrite life insurance. This provision ignores the desirability of exclusive state regulation of an insurance company. The geographic and demographic differences in our nation demonstrate the need for close, continuous and accessible regulation. State insurance departments have proved their ability to perform their insurance responsibilities in the best interest of the consumers of the individual states. Insurance departments have ably administered their trust through market conduct examinations and vigorous enforcement of the unfair trade and claims practices acts. In the area of their prime concern, solvency, time and time again state insurance regulators have proved themselves up to the task. With insurance underwritten through a separate corporate affiliate of the bank holding company and regulated totally at the state level, we see very few bank entry problems arising from overlapping supervisory responsibility or conflicting regulatory

JOHN B. CARTER
President and
Chief Executive Officer

requirements. A separate affiliate would simply have to comply with existing state law and regulations. A two-headed regulatory system of banking and insurance would lead to competitive inequities among insurers in the same market.

Tying

In addressing the tying problem, the FDIC assumes the sanctions in section 106(b) of the Bank Holding Company Act [12 U.S.C. 1972 (1) (B)] together with its proposed amendment to section 332.7(4) applying to banks not within bank holding companies, to be adequate protection against tying. Unfortunately, the fact is that explicit anti-tying statutes have been on the books for years but have signally failed even against blatant tying. FTC and Federal Reserve Board studies have verified that the Sherman Act and Bank Holding Company Act have not curbed this abuse.

The passive tie-in frustrates all attempts at legislative drafting. As long as a single bank organization is permitted to market connected insurance products, the evils of the passive tie-in will persist. Few borrowers, sophisticated or not, can miss the implication that purchasing insurance from a bank will help him or her obtain a loan. That is a form of coercion too subtle to prove or prevent and one that the bank cannot avoid exerting.

The tie-in issue has eluded all attempts to solve it. A suggestion that might be developed is that a bank be subject to a moratorium on selling or underwriting insurance whenever it makes a loan on either commercial, home or chattel. In commercial lending, particularly a relationship between lender and borrower, builds and the certainty of an eventual insurance tie-in is inevitable. These premiums are very large and in today's market, competition for this business is very intense, which creates strong pressures to employ a tie-in.

More than ever, the NAII believes that Congress should be the sole source for resolving all the issues pertaining to bank deregulation or diversification, not the states, courts or federal agencies. By dismissing this sound view, FDIC is really increasing and complicating the activity which deepens the risk of eventual chaos in the financial services market.

Thank you, again, for the opportunity to comment on this proposed Regulation.

Yours very truly,

John B. Crosby

John B. Crosby
Vice President & General Counsel

JBC:kk

cc: Messrs. Beck, Coover,
Lorenz and Wiles.

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JOHN B. CROSBY
VICE PRESIDENT & GENERAL COUNSEL

February 8, 1985

FEDERAL EXPRESS

Mr. Hoyle Robinson
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Notice of Proposed Rule Making
Federal Register, Volume 49 No. 241

Dear Mr. Robinson:

The National Association of Independent Insurers (N.A.I.I.) welcomed the opportunity to respond to FDIC's Advance Notice of Proposed Rule Making (FR Vol. 48, No. 177) on November 10, 1983. In studying this proposal we are grateful that our previous efforts were not in vain, yet we are disappointed that some of our salient points were disregarded in such an extenuated manner. We remain convinced that the FDIC's policies for "soundness of banking" and "promoting stabilizing and confidence in (the) nations banking system" are in jeopardy by allowing banks to underwrite insurance.

The N.A.I.I. is a voluntary national property and casualty trade association of more than 530 member companies. Our members range from small one-state writers to the very largest national writers. They are stock, mutual and reciprocal companies and they use a variety of systems to merchandise the insurance product from agency to direct writer and direct mail. Our members underwrite approximately 32% of the insured automobiles and 24% of the insured homes in our nation.

Fundamentally, we do not take a prohibitive position against any competitive venture into insurance underwriting, assuming such an entity stands in parity with insurers now in the market place. However, we are aware that banks have many competitive advantages not available to insurance underwriters and, until this imbalance is corrected, we continue to support for all banks the full impact of Section 4(c)8 of the Bank Holding Company Act.

Given the role of the FDIC, we question the purpose of its intention to promulgate these Rules as they apply to the underwriting of property and casualty insurance. Surely the profound national policy decisions that must be made in the area of bank entry into other commercial enterprises, requires thoughtful consideration by Congress.

Apparently, FDIC had given this some reflection when it included sec. 332.3(b) and sec. 332.9 in the proposal. Though the proposed Rules may not in our judgment create a massive move by banks to establish or purchase insurance subsidiaries for the purpose of property and casualty underwriting, the conclusion will provide added support for those interests that propose banks be allowed to enter any business enterprise they care to, without regard to safety and soundness.

We lauded the FDIC in November, 1983 for asking some very timely questions concerning the effects of bank deregulation and the risks involved. Recognizing that current law and regulations preclude bank entry into insurance underwriting, the FDIC's proposed rules may only have a trivial effect on immediate banking practices. However, the conclusions the FDIC reached will, we fear, have an undesirable influence in the deliberations in Congress as well as the basis for other regulatory bodies to complement their own advocacy on behalf of the powerful banking interests.

We share the respect that most have in the integrity and credibility of the FDIC. Frankly we are disappointed in the apparent lack of thoughtful consideration it gave to the obvious risk factors that prevail in property and casualty insurance underwriting. For example, what is the basis of the assertion that the skills required for property and casualty underwriting are comparable to the risk assessment a bank loan officer undertakes. Without belaboring the obvious lack of skills of many bank loan officers in recent years in lending their bank's money, would the same commentator also assume that an insurance underwriter could double as a bank loan officer? Would the commentator be willing to hire an underwriter in such a capacity for his/her bank? We doubt that the answers would be in the affirmative. The commentator obviously was out of touch with property and casualty insurance underwriting reality.

The FDIC seems to give great weight to the Department of Justice submission that insurance activities are not substantially riskier than traditional banking. We are not aware that the DOJ is a repository for any significant property and casualty insurance knowledge and question their conclusion in this regard. Of course we disagree with DOJ's conclusion but assuming arguendo that the DOJ is correct, does the FDIC with the problems it has had with the safety and soundness of banks really want to bargain for banks under

their charge to enter into a non-protected and highly competitive enterprise which is riskier but not substantially riskier than protected and coddled banks? How can the FDIC justify such a position?

A Bonafide Subsidiary

The requirement for and definition of a bonafide subsidiary is evidence that the FDIC recognizes some of the problems we pointed our in our earlier submission. We agree that all ingredients listed in that Rule will go a long way to allow the proper regulating authorities to discharge their respective responsibilities. However, we urge the FDIC to require non-banking activities of a bank be through an affiliate rather than the subsidiary. The Administration has conceded that it would be fundamentally unfair to allow only a downstream subsidiary.

Naturally the FDIC's concern is to insulate and protect the bank. Our primary concern is the solvency of the insurance entity. It is essential to safety, soundness, and operating logic that insurance underwriting services be conducted by a separate affiliate, not through a subsidiary. For the protection of policyholders, insurance departments must have a means to conduct surveillance of a company, to enforce regulations, to examine asset and dividend transfers between the parent, its affiliates, and its insurance unit. In addition, financial soundness and policyholder rights demand that the assets of an insurance unit be segregated from raiding by the parent or non-insurance affiliate which may be experiencing adverse economic results.

The insurance marketplace can function only if there is a reasonable certainty that the company will be able to pay future losses. In most other transactions, the long-term financial viability of the seller is of no concern to the consumer, but in the business of insurance, future solvency is absolutely essential. The insurance consumer must be protected by regulators knowledgeable in the areas of the financial condition of the insurance company, fairness of the price, the adequacy of the coverage in the policy forms, and the quality of service. Only when a separate affiliate exists can the state regulatory authorities accomplish their duties in the licensing of insurance companies and agents, examining financial condition and claims practices, implementing the statutory standards that rates shall not be excessive, inadequate, or unfairly discriminatory, administering complaint handling, enforcing unfair trade practice laws, regulating residual market mechanisms (i.e. Assigned Risk Plans and FAIR Plans designed to provide insurance for risks rejected by the voluntary insurance market), and applying for orderly liquidation, rehabilitation or conservation of companies because of financial impairment.

Property and casualty insurers have provided for the protection of consumers from insolvency by promoting legislative enactment of guaranty fund legislation in all 50 states. A guaranty fund provides that insurers doing business in that state, in proportion to their market share, must pick up the losses suffered by consumers due to an insolvency. It would not be specious to conclude that this arrangement can operate effectively only when the insurance operation is conducted through a separate affiliate regulated like all other insurers.

Ignoring Evidence of Increased Risk

The FDIC's proposal to insulate insured banks from risk by placing insurance underwriting activities in a separate subsidiary ignores evidence that such activities may threaten the bank's safety and soundness. Allowing banks to underwrite property and casualty insurance is inconsistent with the purposes of Federal Deposit Insurance Law. Insured banks should be prohibited from engaging in property and casualty insurance underwriting, whether or not the activity is carried out through a separate subsidiary or independent affiliate, unless higher risk-based premiums are charged the insured bank.

Empirical studies demonstrate that underwriting property and casualty insurance is riskier than traditional commercial banking and, in fact, even more risky than the combined banking and nonbanking activities of bank holding companies. In this regard, property and casualty insurance underwriting can be distinguished from life insurance underwriting and from insurance agency and brokerage. Underwriting non-life insurance involves substantially greater risk than other insurance activities. Additionally, the risks inherent in underwriting property and casualty insurance are positively correlated with traditional banking risks. Permitting bank holding companies to engage in this highly risky insurance activity will magnify the overall riskiness of the enterprise.

Recent experience in both the insurance business (Baldwin-United) and the banking business (Continental Illinois) indicates that subsidiary arrangements do not provide a fail-safe method of immunizing holding companies from problems, risks and losses that may arise from subsidiary operations. Whenever bank holding companies control and coordinate subsidiary activities, as would be the case under the proposed rules, problems in one area of the operation inevitably affect all areas. There is every incentive for bank holding companies to draw on all their available resources to help a troubled subsidiary. It is unrealistic to assume that subsidiaries within the holding company structure could fail without any effect on the safety and soundness of banking operations. There is nothing in the proposed rules that lessens the likelihood that past experience with real estate investment trusts and other banking

adventures would not be repeated if insurance underwriting activities were sanctioned.

The FDIC's discussion of its proposed rules indicates that an insured bank's direct investment in an insurance underwriting subsidiary would not be counted toward the bank's regulatory capital. Moreover, the adequacy of the subsidiary insurance company's capital will become subject to banking regulation. Setting aside the obvious regulatory overlap, this proposal seems to assure that adverse operating results in one area of the enterprise will weaken the financial condition of related companies. For example, suppose a subsidiary property and casualty insurer that has been experiencing chronic underwriting losses, finally recognizes that it must strengthen its claims reserves. Reserve strengthening depletes the insurer's statutory net worth below minimum capitalization requirements. Funds therefore are transferred from the bank through the holding company to shore-up the insurer's capital. When the transaction is completed, both the bank and the insurer are able to report compliance with minimum capital requirements. However, the bank clearly is in a weaker position than it otherwise would have been and it is much more vulnerable to fluctuations that might arise from its own banking activities. Unless capital requirements for banks affiliated with insurance underwriting subsidiaries are differentially higher than requirements for other less risky banks, the proposal can only be viewed as inconsistent with safety and soundness objectives. Charging banks engaged in insurance underwriting higher risk-based premiums would contribute to a more equitable deposit insurance system but would be a less conservative alternative than prohibiting insurance underwriting activities altogether.

Agents Services, Conflict of Interest - Tying

The proposal invites comments on section 332.8. As previously stated we continue to support the principle enunciated in section 4(c)8 of the Bank Holding Company Act and therefore oppose banks acting as insurance agents. Though the FDIC's concerns for safety and soundness are not evident, surely the inherent and certainty of conflicts of interest and tying of the insurance product with the extension of credit cannot be dismissed so summarily as this section would indicate. This section requires comment on the following areas: (1) direct agency through a bank; (2) notice to the customer of the capacity in which the bank employee is acting; and (3) tying.

Direct Agency

We consider a dual employment arrangement to be much more insidious than one by which the affiliate employees act independently in offering their product or services. It would naturally aid the cause of preventing a passive tie-ins if the customer must be

contacted by a third party to discuss the customer's insurance needs. A bank employee, acting in a dual employment role, falls short of the expertise necessary to determine insurance needs. The commercial insurance area particularly requires personnel with special expertise. A bank employee granting loans cannot be all things to all people. It takes years of understudy and experience to properly assess risk and discern coverage just as it takes years of understudy and experience to become a qualified loan officer of a bank.

Notice to the Customer

Disclosure must be required in any conflict of interest situation. However, mere disclosure would not alleviate the problem, because it would not help the customer make an informed and independent choice as to whether the best product and service is being obtained for the best price. Disclosure might even enhance the banks' standing and improve its chances for a passive tie-in by emphasizing the connection.

Tying

Our concern in any enabling statute or regulation allowing banks to act as agent for insurance is the conflict of interest problem. Insurers and banks have been in conflict with each other for over half a century. We see no end to this conflict however the future of financial integration manifests itself. The boycott of specific insurers and the use of credit leverage to tie in the sale of insurance are ready examples of this conflict. How much more serious this abuse will become in the event banks are allowed to sell insurance, through the same company, is a question full of risk for the public.

Existing federal laws, such as the anti-tying provisions of the Bank Holding Company Act amendments of 1970 (12 USC 1971), are not sufficient safeguards against these abuses. It is unlikely that banks would be so bold or blunt as to require purchase of their insurance as a condition for granting a loan because this outrageous activity would without question fall under the purview of the anti-tying provisions of the Bank Holding Company Act and the antitrust laws.

More pervasive and not as easy to identify or control is the passive tie-in. The subtle implication that fills the air while one is making out a loan application and the question about insurance is encountered is a form of coercion, but one that is impossible to prove or prevent and one that the bank cannot avoid exerting. Conceding that the lender has done its level best to assure the applicant that he or she does not have to buy the bank's insurance to get the loan, nevertheless the inference persists, particularly among less sophisticated borrowers, that this will in some way help

them obtain that loan. The tie-in issue has eluded all attempts to solve it, short of a prohibition precluding banks from selling or underwriting insurance in any case. The Garn-St. Germain Act of 1982 strengthened up the prohibition in 12 USC 1843(c)(8) of the Bank Holding Company Act. Of course, it is naturally this very provision that the interested banks are attempting to skirt at this time.

Increased Concentration Due to Capital Requirements

The FDIC claims that there will be no increase in the concentration level of the banking industry due to its proposal. However, the requirement that a bank's investment in an insurance subsidiary be separate from its regulatory capital makes it more difficult for smaller banks to expand into insurance activities. Although this requirement is meant to prevent thinly capitalized banks from venturing into the insurance business, it will limit insurance underwriting to only those banks or bank holding companies that have substantial excess capital. It is clear that small banks and banks without upstream holding companies may not have the excess capital to establish or purchase insurance affiliates as would larger banking institutions. In addition, smaller banks that seek to enter insurance underwriting will find de novo entry most economical while larger, better capitalized banks will be able to acquire existing insurers. This will allow larger banks to establish more rapidly their position in the market to the detriment of smaller banks' incipient insurance underwriting subsidiaries. Big banks will become even bigger bank-insurers. The FDIC's capitalization requirement will increase further the level of concentration in banking, an industry in which the top 10 banks already control 25 percent of the total banking assets.

We appreciate the opportunity to comment on this proposed Rule. If we can be of further assistance in any of your deliberations, please call on us.

Yours very truly,

John B. Crosby
Vice President & General Counsel

JBC:kk

Senator RIEGLE. Let me just ask one other thing. It concerns the potential for tying relationships between the credit institutions and other financial services, insurance, or securities, or whatever other things.

TYING RELATIONSHIP

I'd like to just hear you express what your concern is on the tying relationship and why you emphasized that as strongly as you did a while back.

Mr. CARTER. I'll wax a little philosophic. I think as a former sales manager whose basic job was to help people create customer relationships and lever sales through those relationships—that's really what selling life insurance and selling lots of things are—it's a very natural thing once having made a sale to cement that relationship to lever it into other product lines.

If I happen to be a loan officer of a bank and I have established such a relationship, and in that case I handle the granting of a loan, it's natural for me to want to put credit life insurance or whatever the case may be—property and casualty insurance—up against that loan. Then you go and say, "OK, that's theoretical, let's go look at the history." I believe in the State of Missouri they had a bank holding company and four of their subsidiary banks were brought to task. I believe in each case every loan made by each of the four banks had credit life insurance attached to it and every credit life insurance policy was issued through the bank that had made the loan, 100 percent penetration of that loan portfolio.

You and I know that reality didn't dictate that type of performance, and that's a classic case of tying.

If you want to see a really pitiful case of it, Senator, I believe you will find in the lead column of the Wall Street Journal of February 26 of this year a most unusual story about a Miss Snow, who was an unwed mother who needed money before Christmas. She went down to the local loan company—in this case, not a bank—and got a loan for $176 and then had credit life insurance put in on it, had property and casualty insurance put up against it, had term life insurance put up against it, and just to top it off she got for $25 more a membership as a good credit customer of ITT. She ended up borrowing more than $500 to get the $176 loan. So that's a case of tying.

Senator RIEGLE. Well, the tying problem concerns me as well, not necessarily in this extreme case as that one which I happened to see too in the Wall Street Journal, but it seems to me that we've got a natural relationship and we have had major banking figures in this country say that if their name is on the door of the subsidiary as well as the major banking institution that when the crunch comes they are going to stand behind the subsidiary with every ounce of their strength, no matter how you try to seal it off. And I sometimes get a little tired about folks saying, "Well, what we really need to do is have a nice structure of law that, provides these nice clean definitions." We just had another action yesterday against a series of financial institutions because of money laundering. I'm talking about major institutions. Well, that's against the law and we see this and say, "Well, wait a minute. How can this

happen? The law prevents this." Well, if you design the law so that it's very difficult to work or it invites abuse or it enables abuse, we ought not to be surprised when abuse takes place.

I think the system that we have works pretty well and I'm not sure that the problems that we have today are the fault of the system not working well. So I have yet to hear a convincing case to say that the answer to the problems that are piling up is to somehow reshuffle all the cards and if we do this then suddenly our problems are going to go away. I think that's nonsense because I don't think that's where our problems derive from.

So in any event, I am very conservative about these issues. I think the burden of proof has to rest on those who want to shuffle the cards in a completely different way. I think the system has worked pretty well.

Mr. CARTER. Senator, I would say that I don't think a new comprehensive law has to throw out everything in the past just to be different. In fact, if any CEO worth his salt in the top-most organization of a chain with subs of various kinds doesn't come down there and rescue his subs that are in trouble, he's not doing his job. The people who have done business with those subs know that and depend upon it.

We in our company have done that several times in the last few years at great personal cost, but there is no option. And to say you're going to wall that off with some legality and get rid of that moral obligation is nonsense.

Senator RIEGLE. Let me ask you if I may to respond to my other questions in writing, and also I want to say to the other panel that I'd like to be here for their discussion but I will read their presentations and I would like also to have those members respond to questions and also say I'm please that one of those members is an insurance person from Michigan.

[Response to written questions of Senators Garn and Riegle follow:]

JOHN B. CARTER, President and Chief Executive Officer, The Equitable Life Assurance Society of the U.S., New York, NY; on behalf of the American Council of Life Insurance

Senate Banking Committee Questions

Senator Garn:
Question #1

Aren't insurance companies a primary source of long term capital to the financial markets and as such don't insurance companies control credit access?

Senator Garn:
Question #2

When an insurance company makes a private placement loan, is the borrower subsequently contacted by an insurance agent for the purpose of offering insurance products or services? How does that situation differ from the extension of credit by a bank and subsequent availability of other financial products and services from the bank?

Answer:

Credit leverage can only be exercised when the lender has real or perceived economic power over the borrower. Where there are other equally accessible sources of credit for a borrower, or where the borrower has substantial economic power in his own right, a lender will find it difficult to coerce the borrower to accept unfavorable terms or conditions in connection with a credit transaction. In the long term capital market where large numbers of competing lenders are typically accessible on an equal basis to highly sophisticated and economically substantial borrowers, there is little credit leverage to exercise. This is essentially the market in which insurers find themselves.

The situation is far different in the short term commercial and consumer lending area. These borrowers are generally less sophisticated and of less substantial means. Moreover, the commercial banks which dominate this market are generally reluctant to lend to those that are not regular customers. Thus, as a practical matter, the bank with whom one conducts his regular banking business is also his principal source of credit. The exclusive nature of this relationship confers on the banks significant economic leverage over such customers. Historically, banks have actively sought to use this leverage to encourage the sale of additional products such as credit insurance. This fact is extensively documented. Insurers do not have this sort of economic power over their credit customers. Not unexpectedly, therefore, there is no history of insurers attempting to coerce their customers to purchase additional service as a condition of receiving an extension of credit.

If insurers do control credit access as a primary source of long term capital to the financial markets, which is highly questionable, they do so only in a collective sense, not individually. The same is not true for bankers in their market.

Senator Garn:
Question #3

You have expressed concern about banks assuming new and uncertain risks when they are protected by taxpayer-funded FDIC insurance. Would a system of risk-based FDIC insurance premiums present a more equitable solution than the prohibition of expanded services? Wouldn't regulation by function also be a more prudent form of regulation?

Answer:

Risk-based FDIC insurance premiums would perhaps be a more equitable means of funding deposit insurance within the banking community. It would not, however, address the concern which we have expressed regarding the Federal safety net (including deposit insurance), which is that depository institutions are the only financial intermediaries that enjoy such protection. As for regulation by function, it is neither a totally adequate answer to regulating already permissible cross-industry activities nor an answer to problems with expanded bank powers. Variable annuity contracts issued by insurance companies are one example of the shortcomings of functional regulation. These contracts are categorized as both insurance and securities and are duly regulated by the States and the SEC. A variable contract funded by a deposit account would, consistent with the theory of functional regulation, also be regulated by the appropriate bank regulators. As we have stated many times in the past, we are not persuaded that the establishment of subsidiaries would solve the problems of compounding risks or that the establishment of subsidiaries would in fact maintain the stability of financial institutions or protect the publics they serve.

Senator Garn:
Question #4

A number of insurance companies are now using a variety of methods for distribution of insurance products including direct mail solicitation and joint ventures with other financial institutions. Doesn't this trend indicate that some consumers may be satisfied with these types of distribution systems for insurance products? If so, shouldn't these joint ventures be encouraged?

Answer:

The alternate distribution methods you mention are permissible under current law and do not involve "deregulation" of the banking industry. The American Council of Life Insurance does not have a policy discouraging these arrangements.

Senator Garn:
Question #5

The (NAIC) National Association of Insurance Commissioners has adopted a Model Unfair Trade Practices Act which requires a lender who solicits insurance to explain in writing to the borrower that insurance related to the extension of credit may be purchased from an insurer or agent of the borrower's choice. In certain circumstances that Act would require that a commitment in writing as to a loan or credit extension be made before the lender may solicit insurance.

Doesn't that type of provision alleviate your concerns about tying sales of insurance to the extension of credit and still allow the consumer to have a broader range of choices available? If so, why can't it be applied to the banks? If not, should the NAIC be tougher and prohibit cross selling?

Senator Garn:
Question #6

If your concern lies with consumer protection, isn't it preferable to require disclosure of the right to purchase insurance elsewhere and require a loan commitment to be made before insurance is solicited by the lender rather than restrict the consumer's available choices for obtaining insurance?

Answer:

The use of credit leverage to tie an extension of credit to the sale of other products and services (credit insurance in particular) is widespread despite very explicit laws prohibiting such activity. The mere enactment of additional statutes in this area is, therefore, not likely to deter the use of credit leverage, especially when there is intense pressure from bank management to sell more products and services to produce additional revenues. Written disclosure notices are all well and good. However, when both the loan officer and the prospective borrower know that a particular loan is essential to the economic viability of the borrower's business, the loan officer will drive as hard a bargain as he can, and the borrower will go along with it, written disclosure or no.

The fact is that the temptation to condition the granting of a loan on the purchase of additional products or services when a borrower comes with hat in hand is simply too great to be deterred by statute, unless, of course, credit leveraging were to be made a capital offense.

Senator Garn
Question #7

Some suggest that the consumers interest in freedom of choice is being forgotten in this debate. For example, Consumer Bankers points to a 1984 survey conducted by the American Council of Life Insurance in late 1984 which shows that 59% of the respondents believe that banks would do a good job of providing one-stop financial services. How would you respond to the suggestion that based on your organization's own survey you are denying the consumer the right of choice?

Answer:

We have carefully reviewed our 1984 survey results on bank entry into life insurance and find no statement that 59% of the respondents believe banks would do a good job of providing one-stop financial services. Some results that the survey does contain that may be of interest to you include the following: (i) a three-to-one majority believes that advice and guidance from a trained life insurance professional is necessary in purchasing life insurance; (ii) 57% of those surveyed said that a bank's personnel would not spend as much time discussing with clients which policy was best suited for them as the life insurance agent would; (iii) 64% of those surveyed said that bank personnel do not have the expertise and background for selling life insurance; and (iv) 44% of those surveyed believe that a bank is more likely to approve a loan if the person buys life insurance from the bank.

Senator Garn:
Question #8

In his testimony on behalf of Acacia Insurance Company, Mr. Evans indicated that many insurers will not be able to survive if they are restricted to their narrow markets. Do any of your members agree? Disagree? Please explain both positions.

Answer:

In the coming years there will undoubtedly be numerous banks and life insurance companies that will not survive. We do not share the view, however, that the cause of these institutional failures can be laid to the inability of life insurance companies to become banks or the inability of banks to become life insurance companies. Furthermore, as you will note from our responses to subsequent questions, e.g., question #13, both banks and insurance companies have under existing laws been able to introduce major innovations in the financial services area. As to Mr. Evans' statement we believe he is in a far better position than us to elaborate on his position.

Senator Garn:
Question #9

The Conference of State Bank Supervisors argues that the legislative history of the 1956 Bank Holding Company Act and its subsequent amendments of 1966, 1970, 1980, and 1982 is clear. The concept of the Act was to regulate bank holding companies and not their subsidiary banks. The passage of the Bank Holding Company Act or its amendments was not meant to override the dual banking system. Please find enclosed a copy of a letter from CSBS to the Federal Reserve Board and respond to each point raised in the letter.

Answer:

We believe that the legislative history of the Bank Holding Company Act, particularly the amendments to that Act passed in 1982 relating to insurance (Title VI of the Garn-St. Germain Act), indicate clearly that the insurance limitations of Section 4(c)(8) were intended to apply to all entities in a holding company system, including banks. Rather than attempt to restate what has already been extremely well articulated, we are enclosing for your information a copy of the Memorandum of Law that we filed before the Federal Reserve Board in connection with Citicorp's proposed acquisition of a South Dakota bank. This Memorandum addresses all the points raised in the CSBS letter.

Senator Garn:
Question #10

At a previous hearing, Mr. Friedman with Arthur Andersen and Co., presented studies that company had performed regarding various segments of the financial services industry. Concerning the life insurance industry, he assessed the current strategy as being that of:

1. offering new products

2. cutting distribution costs

3. paring operating costs

Would you share with us whether Equitable is following this three prong strategy and some of your plans?

Answer:

Equitable is following the three prong strategy outlined above. For example, we have been on the leading edge in developing and marketing a wide variety of traditional and new interest sensitive life insurance products including: variable life insurance, adjustable life insurance and universal life insurance. In addition, a second generation variable life insurance product and a group universal life insurance product are under development.

As to cutting distribution costs, we have substantially reduced the number of our regional and local agency offices and have pared down the size of our Agency Force by terminating agents who do not meet average agency standards.

As to paring operating costs, we have achieved substantial savings by reducing corporate staff and merging various operating areas. In addition, we have consolidated many of our regional offices and have sited several operations in less expensive real estate.

We continue to look closely at the development of new products and to finding other ways for cutting distribution and operating costs.

Senator Garn:
Question #11

In your 1984 annual statement, you state "to broaden the range of products and services offered by Equitable agents, the Company created Equinet ... Equinet enters into contracts with other suppliers of insurance and financial services..."

What kinds of joint ventures have you entered into? Should banks or bank holding companies be expressly authorized to enter into similar joint ventures in the distribution of insurance?

Answer:

Following are some examples of the types of arrangements we have entered into in the financial services area. Two of our subsidiaries have entered into a discount brokerage arrangement. Other arrangements we have made with sponsors of mutual funds, unit investment trust and direct participation programs are available through Equitable's broker/dealer subsidiary. We have made arrangements with other companies for the marketing of their life, health and small group products. We have also leased space on bank premises at which Equitable agents sell Equitable insurance. As previously indicated the American Council of Life Insurance industry does not have a policy discouraging such arrangements with other financial institutions.

Senator Garn:
Question #12

In your annual statement, you also suggest that you are expanding the number and types of distribution systems through which Equitable products are marketed. Could you please explain?

Answer:

Equitable insurance products and the insurance products of our variable life insurance subsidiary (EVLICO) are marketed through our agency system. However, we have purchased other companies which will market similar products under their own names. For example, one of these will sell single premium deferred annuities through unaffiliated insurance brokers, general agents and insurance licensed registered representatives of retail broker/dealers. We also plan to have this company sell a flexible premium variable life insurance product through the distribution facilities of other insurers (generic labeling). We may in the future consider further acquisitions to serve specialty markets.

Senator Garn:
Question #13

Again in your annual statement you state:

> "Equitable people look back on a history of innovation in the insurance industry. Today and on into tomorrow we are writing a history of innovation in the financial services industry."

It seems that you agree that today we are in the financial services industry. If you weren't permitted to evolve with the marketplace, wouldn't your days be numbered? Why should banks be prohibited from evolving? Wouldn't that be unsage and unsound?

Answer:

Many of the financial services innovations that Equitable and other life companies have undertaken in recent years have been centered in the development of new insurance products, such as universal life insurance and variable life insurance. The objective of these new products has been to better accommodate the insurance needs of our customers in a changing world. To serve our customers better, we have also moved to improve the flexibility and reduce the costs of insurance distribution. The general objective in both product development and distributional performance has been to enhance the attractiveness of insurance, the sector of financial services market in which our companies are most expert.

The commercial banking industry has also introduced major innovations recently in its areas of primary expertise. For example, they have experimented with such things as floating rate loans, time deposits free of interest rate ceilings, and loan rates tied to quotes in the Euro-dollar market. In addition, banks have been authorized to offer certain newer types of services where the function is closely related to banking--including such services as discount brokerage and

investment advisory services. Thus, there has been ample leeway for banks to innovate in both their traditional markets and in newer markets closely related to banking.

It is true that Equitable and other life insurance companies have diversified into financial services beyond traditional boundaries. However, such diversification has been done in accordance with existing law which establishes a level playing field. It is also existing law which has limited further diversification by banks. Such law recognizes the unique nature of banks. The fact is that banks are different from any other kind of enterprise. They play a unique role in helping to assure the basic liquidity of our economy, in serving as the link between the central bank and in implementing monetary policy. They have been granted special privileges by the federal government in the form of FDIC insurance, access to the Federal Reserve discount window and various tax advantages. Because they are the primary source of credit for individuals and small businesses, they have unique power over the economic well-being of the American consumer. So when banks petition Congress to permit them to enter new markets from which they have been barred by long-standing federal policy, they do not do so as just another competitor.

Our concern is that Congressional acquiescence to current bank demands for additional nonbanking related powers will risk a serious further weakening of the banking system as a whole. The banking system is much too important to the general well-being of the U.S. economy to subject it to such risks.

Senator Garn:
Question #14

Do you believe the offering of savings banks life insurance is unethical?

Answer:

Savings bank life insurance was created as a social program to benefit citizens with low incomes at a time when that market segment was not well served. Today, all segments of the insurance marketplace are adequately served by existing life insurance companies, and there is no need to expand the existing boundaries of SBLI. This fact explains why the market share of SBLI has been in steady decline for the past few years. In addition, we do not believe that the regulatory model governing savings bank life insurance lends itself to broader bank insurance involvement nor do we believe that the savings bank life experience demonstrates any meaningful bank "experience" in the life insurance business.

Senator Garn:
Question #15

Is your organization in favor of complete divestiture of nonbank banks? Why or why not? Should the lines between banking, insurance and securities be redrawn?

Answer:

As I stated in my testimony, I believe that you will find that the heads of most life insurance companies with nonbank banks would be willing to relinquish their banking interests provided the South Dakota loophole is closed. This answer suggests that the existing delineation between banking and commerce is drawn appropriately and simply needs to be enforced.

JOHN B. CARTER, President and Chief Executive Officer, The Equitable Life Assurance Society of the U.S., New York, NY; on behalf of the American Council of Life Insurance

Senator Riegle - Questions and Responses

Senator Riegle
Question #1

In has been brought to my attention that property and casualty underwriters are beginning to face some real economic problems.

Are these reports accurate and, if so, how would you describe the present financial difficulties encountered by property and casualty underwriters?

In light of your assessment, how would you compare the riskiness of property and casualty underwriting to the normal business risks undertaken by a bank?

Answer:

Inasmuch as I was representing the life insurance industry at the Committee's Hearings, I do not believe it would be appropriate for me to comment on the status of the property and casualty industry.

Senator Riegle:
Question #2

I understand that Bank of America recenly withdrew its application to acquire a South Dakota Bank that would have been empowered to sell insurance. The Federal Reserve Board had been considering whether such an acquisition is permitted by the Bank Holding Company Act.

In your view, what are the implications of Bank of America's action?

Answer:

Bank of America's letter to the Federal Reserve Board withdrawing its application to acquire a South Dakota bank did not set forth any explanation for that action. We can only surmise that Bank of America had second thoughts and on reflection did not feel that the acquisition of a South Dakota bank for the purposes of entering into the insurance business would be in the best interest of the bank.

Senator Riegle:
Question #3

This question is really unrelated to the subject of our hearing today, but I wonder whether you could take a minute to explain to us the effect on the insurance industry of the President's recent tax reform proposals?

Answer:

While many of the President's recent tax reform proposals have merit, the life and health insurance industry is gravely concerned about the consequences of proposed tax increases on (1) individuals who purchase life insurance policies and annuities, (2) employee benefits, and (3) the life and health insurance business. These concerns are more fully set forth in the attached statement of the American Council of Life Insurance presented to the House Ways and Means Committee on July 19, 1985 and the attached statement of the Health Insurance Association of America presented to the Committee on July 10, 1985.

Senator Riegle
Question #4

We know that banks are interested in engaging in the insurance business and there are indications that insurance companies are interested in the banking business. For example, Prudential recently announced its intent to offer home mortgage loans through its agents.

How do you respond to the argument that banks should be as free as insurance companies to expand their activities?

Answer:

Historically life insurance companies have offered home mortgage loans so Prudential's announcement is not particularly innovative nor indicative of an interest in the banking business. As to the argument that banks should be as free as insurance companies to expand their activities, I think this has been covered in our response to Senator Garn's question #13. As pointed out in that response, our concern is that Congressional acquiescence to current bank demands for additional nonbanking powers will risk a serious further weakening of the banking system as a whole. The banking system is much too important to the general well-being of the U.S. economy to be subjected to such risks.

National Association NAII of Independent Insurers

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JOHN B. CROSBY
VICE PRESIDENT & GENERAL COUNSEL

July 15, 1985

via: Federal Express

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
Washington, D.C. 20510

Dear Senator Garn:

This is in response to your letter of July 1, 1985, posing follow-up questions as a result of my oral testimony before your Committee on June 19, 1985. The NAII member companies are property and casualty insurers, merchandising the insurance product in a wide variety of ways, including independent agency, direct writing and mail solicitation. We do not represent these companies in life insurance or accident and health insurance matters and, thus, will limit our answers to some of the questions posed to our area of expertise, i.e. P/C insurance.

1. Aren't insurance companies a primary source of long term capital to the financial markets and as such don't insurance companies control credit access?

Answer. Property and casualty insurers are not generally considered a source for long-term capital to the financial markets and, therefore, have little control over credit access. Our companies do invest in stocks and bonds, however, the primary goal of a financial manager in these companies would be to maintain a liquid position for the payment of claims in the volatile field of liability and catastrophic events. Our friends in life insurance underwriting who are favored with more predictable loss projections and have access to pension fund activities may be able to shed more light on this subject.

2. When an insurance company makes a private placement loan, is the borrower subsequently contacted by an insurance agent for the purpose of offering insurance products or services? How does that situation differ from the extension of credit by a bank and subsequent availability of other financial products and services from the bank?

Answer. With the exception of a few property and casualty companies which may have an affiliate or a subsidiary that does lend on private placement basis, the companies do not provide such funds. If and when such a practice does take place, however, we find no difference with that practice and a bank's subsequent contact for other financial products/services.

3. You have expressed concern about banks assuming new and uncertain risks when they are protected by taxpayer-funded FDIC insurance. Would a system of risk-based FDIC insurance premiums present a more equitable solution than the prohibition of expanded services? Wouldn't regulation by function also be a more prudent form of regulation?

Answer. The system of risk-based FDIC insurance premiums if, in fact, they were truly actuarily risk-based and not subsidized by the taxpayers, would go a long way to allaying our concerns. We are concerned further about the propensity for banks taking funds generated by American citizens and lending those funds to foreign countries to garner more interest, knowing that in the end the International Monetary Fund will bail them out. Many federal or quasi-federal programs also favor banks with certain guarantees, such as FHA, GMAE, etc.

On the question of regulation by function, we urge that in any bill passed by Congress, this would be a requirement. Our primary concern about banks assuming risks, when they are protected by taxpayer funded programs, would be alleviated if banks were required to use their own surplus funds to start up an insurance company de novo, rather than investing in a going company in an already capital-starved industry using depositors' funds and then leveraging the purchase. The latter scenario adds nothing to an industry that welcomes and seeks additional capital.

4. A number of insurance companies are now using a variety of methods for distribution of insurance products including direct mail solicitation and joint ventures with other financial institutions. Doesn't this trend indicate that some consumers may be satisfied with these types of distribution systems for insurance products? If so, shouldn't these joint ventures be encouraged?

Answer. It is true that a number of insurance companies are forming joint ventures with other financial institutions, however, the "jury is not in" as to how they are working out and what problems now unforeseen may arise. As we have pointed out on several occasions, no one in any of the financial institutions knows exactly where this trend is going. In the absence of Congressional action they are positioning themselves as best they can under the present laws to avoid being left at the station when the train leaves.

We have heard second hand that some of the joint ventures with banks and insurance agents have not worked out well. Whether or not the public has accepted this or how it will work out remains to be seen. On the question of mail solicitation for insurance products, we represent companies who have been quite successful in personal lines and consider this to be a very viable and credible method of doing business for personal lines.

5. The (NAIC) National Association of Insurance Commissioners has adopted a Model Unfair Trade Practices Act which requires a lender who solicits insurance to explain in writing to the borrower that insurance related to the extension of credit may be purchased from an insurer or agent of the borrower's choice. In certain circumstances that Act would require that a commitment in writing as to a loan or credit extension be made before the lender may solicit insurance.

   Doesn't that type of provision alleviate your concerns about tying sales of insurance to the extension of credit and still allow the consumer to have a broader range of choices available? If so, why can't it be applied to the banks? If not, should the NAIC be tougher and prohibit cross selling?

6. If your concern lies with consumer protection, isn't it preferable to require disclosure of the right to purchase insurance elsewhere and require a loan commitment to be made before insurance is solicited by the lender rather than restrict the consumer's available choices for obtaining insurance?

Answer. (5 & 6) Anti-tying prohibitions are found in the antitrust laws, the Bank Holding Company Act, the Model Unfair Trade Practices Act, and in many state statutes. It is our opinion that without exception all of them are ineffective in this elusive area. FTC and Federal Reserve studies in the past have shown that there is significant tying going on in spite of the sanctions prohibiting it. Our concern also involves the passive tie-in. We feel that a step in the right direction toward solution of this problem would involve a positive written statement at the beginning of any loan transaction that a condition for obtaining the loan bears no relation to the purchase of insurance. After that, a hiatus period before a bank could write or solicit a borrower's insurance should be mandated. We do not think that a year is unreasonable under the circumstances.

7. Some suggest that the consumers' interest in freedom of choice is being forgotten in this debate. For example, Consumer Bankers points to a 1984 survey conducted by the American Council of Life Insurance in late 1984 which shows that 59% of the respondents believe that banks would do a good job of providing one-stop financial services. How would you respond to the suggestion that based on your organization's own survey you are denying the consumer the right of choice?

Answer. First of all, we have not surveyed consumers on this point and apparently this specific question is directed toward the ACLI. We have consistently suggested that the consumer's interests should be paramount in this whole debate, disregarding the selfish interests of all parties. However, we know a little more about the risks and problems involved than the average consumer and must take issue with the judgment of those respondents to the ACLI survey. I have no doubt that banks could do a "good job" of marketing insurance, but at a terrible price to pay within the competitive market. All of our previous concerns come into play at this point. The use of depositors' funds for a highly risky business, the tying of the insurance product, the horror of nonfunctional regulation -- all of which would cause a disruption in the insurance market with the imbalance being in favor of the banks. We have no doubt they would be able to get insurance into the hands of the consuming public.

8. In his testimony on behalf of Acacia Insurance Company, Mr. Evans indicated that many insurers will not be able to survive if they are restricted to their narrow markets. Do any of your members agree? Disagree? Please explain both positions.

Answer. We must suppose that Mr. Evans assumes that banks will be able to underwrite insurance, without leveling the disparity between banks and insurers, and that insurers will not be permitted any banking activity. We trust this would not be the case. We believe that, when Congress acts and the imbalances about which we are concerned are leveled, underwriting of insurance by banks will be required to be done by affiliates with funds from the bank's surplus; that tying language other than the boiler plate that we see in the various federal and regulatory repositories will be firmed up to something much more meaningful; and that the insurance entity will be regulated exclusively by the insurance departments in the various states and banking regulated by the banking regulators, etc. If and when these things occur we have no doubt that our members will survive and find a way to provide banking services of a sort for their policyholders.

9. The Conference of State Bank Supervisors argues that the legislative history of the 1956 Bank Holding Company Act and its subsequent amendments of 1966, 1970, 1980, and 1982 is clear. The concept of the Act was to regulate bank holding companies and not their subsidiary banks. The passage of the Bank Holding Company Act or its amendments was not meant to override the dual banking system. Please find enclosed a copy of a letter from CSBS to the Federal Reserve Board and respond to each point raised in the letter.

Answer. We agree that the skill and capability of management of the bank is the primary factor that should be considered in evaluating entry of individual institutions into various activities. We would disagree that it is preferable for a supervising agency to operate on a case by case basis rather than through the issuance of sweeping provisions, etc. We feel that Congress must address the issues specifically, i.e. whether or not banks should be allowed to underwrite property and casualty insurance. Then the supervising agency should determine on an individual basis whether a particular bank should get into that business. We do not think it advisable to allow state bank supervisors, whose expertise in the area of property and casualty insurance underwriting is nil, to determine whether or not a particular favored bank could get into such a highly risky enterprise.

We disagree with CSBS that the restrictions of Regulation Y should be removed and we have on two previous occasions cautioned the FDIC in its proposals to in effect ignore the spirit of Regulation Y in this regard.

CSBS essentially wants a state exemption for a state bank in a bank holding company to be allowed to do anything it is authorized to do under that particular state law. The NAII and others have been locked in a battle with Citicorp amd others over their purchase of a state bank in South Dakota after the South Dakota legislature without real concern for the substance of what they were about, allowed a state bank to underwrite insurance directly extra-territorially. It is this type of situation that concerns us in the position of CSBS.

The concern of CSBS for the preservation of the dual banking system is satisfactory as far as it goes, as long as the activities involve the state bank standing alone and the responsibility for imprudent management practices fall on that state's citizens. The plea by CSBS is that a state bank should be permitted to do anything authorized by its state legislature even when it is a member of a bank holding company contra to the Bank Holding Company Act, section 4(c). CSBS seeks to allow a bank to do indirectly that which it is directly prohibited under the Bank Holding Company Act and, as such, their plea is a sham. It is specious reasoning on CSBS's part to conclude that the sanctions of the Bank Holding Company Act merely apply to the bank holding company and not to its subsidiaries.

We find no fault in a state allowing one of its state banks to enter into any enterprise in which the legislature of that state after due consideration has deemed to be an allowable venture. In that situation the state takes the responsibility for its actions and the citizens of that state can determine the future of those responsible if an irresponsible extension of state banking powers has been granted.

The legislative and regulatory history cited aside, we look to the latest official legislative enactment in this area - that is the Garn-St. Germain Act, specifically section 4(c)8. We take exception to CSBS's conclusion that merely because a state has allowed an extended power for a state bank, it should be readily accepted as a permissible exemption to the more highly considered and well-thought out legislative pronouncements in the Bank Holding Company Act.

Sincerely,

John B. Crosby
Vice President

July 24, 1985

RESPONSES OF THE
INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.,
THE NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS,
THE NATIONAL ASSOCIATION OF INSURANCE BROKERS,
THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS,
THE NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS,
AND
THE NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS
TO
QUESTIONS POSED BY THE SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

Responses to Questions Posed by Chairman Jake Garn

1. The (NAIC) National Association of Insurance Commissioners has adopted a Model Unfair Trade Practices Act which requires a lender who solicits insurance to explain in writing to the borrower that insurance related to the extension of credit may be purchased from an insurer or agent of the borrower's choice. In certain circumstances that Act would require that a commitment in writing as to a loan or credit extension be made before the lender may solicit insurance.

Doesn't that type of provision alleviate your concerns about tying sales of insurance to the extension of credit and still allow the consumer to have a broader range of choices available? If so, why can't it be applied to the banks? If not, should the NAIC be tougher and prohibit cross selling?

The primary objective of prospective borrowers -- be they individuals or businesses -- when they present themselves to banks to attempt to secure credit is to be given a loan. The control that banking institutions have over the decision of whether to grant or withhold credit confers upon banks significant leverage over decisions made by prospective borrowers regarding other bank services that might be purchased in conjunction with the loan.

The disclosure requirements that would be imposed upon banks by the NAIC's Model Act are, of course, better than nothing. Nevertheless, those requirements cannot be expected significantly to alter the strong economic and psychological advantage that banks have over prospective borrowers in the context of loan

negotiations. As a consequence, requiring banks to provide written assurances that consumers may purchase insurance from insurers or agents of the borrowers' choice merely adds additional paperwork to already paper-laden financial transactions. Moreover, the additional paper would not guarantee that individuals signing disclosure forms have not been subjected to undue influence by banks in the sale of insurance. In any situation where undue influence has taken place, disclosure documents signed by borrowers could result in little more than make it virtually impossible for any consumer to complain after consummation of a loan transaction that insurance had been forced upon him or "highly recommended" by the bank. Documents contemplated by the Model Act might in some instances, therefore, protect the interests of banks more than consumers.

Moreover, in many cases, it would be difficult to require that discussions about insurance take place only after written commitments to extend credit. In almost all lending transactions where collateral is involved, discussions about the collateral and about how that collateral will be protected by insurance are an integral part of loan negotiations. What is more, the details of how collateral will be insured is information that bank loan committees must have in order to make sound lending decisions. Accordingly, to require that insurance be discussed only <u>after</u> commitments to extend credit could be viewed as a requirement that would be unworkable in many lending transactions.

The danger that tie-ins will occur when sales of insurnce are permitted to take place in conjunction with lending activities has

been well documented over many years. In January 1984, a group of the insurance agent organizations provided the Federal Reserve Board with comments on the Board's proposal to amend its credit life insurance regulation. Those comments contained a detailed description of the bank-insurance tie-in problem supported specific examples of instances where tie-in sales have occurred in the past. That document is provided as Exhibit 1.

One of the most recent instances where lender-borrower insurance tie-ins have been officially documented involved ITT's consumer finance subsidiary. A Wall Street Journal article describing ITT's tie-in abuses is provided as Exhibit 2.

2. If your concern lies with consumer protection, isn't it preferable to require disclosure of the right to purchase insurance elsewhere and require a loan commitment to be made before insurance is solicited by the lender rather than restrict the consumer's available choices for obtaining insurance?

The control that banking institutions have over decisions of whether to extend or withhold credit confers upon them the opportunity to exert undue influence on prospective borrowers with respect to insurance decisions. Because the need for insurance often arises in conjunction with extensions of credit, banking institutions are uniquely situated to control the decision concerning the source from which insurance is purchased. As a consequence, banks are in a position to prevent normal insurance marketplace forces from operating. By being able to induce borrowers to purchase insurance from them at the time of the loan for reasons that might have nothing to do with lower price or better service, banks have the capacity to fence bank-insurance transactions away from the rest of the insurance market. In that

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Exhibit 1: Available from the Senate Banking Committee files or from the Board of Governors of the Federal Reserve System, Jan. 24, 1984, Docket No. R-0491.

Exhibit 2: Available from the Senate Banking Committee files or from the Wall Street Journal, Feb. 26, 1985.

way, the insurance marketplace where borrowers could normally shop for insurance on the basis of price and service is never given an opportunity to operate. Over the long term, such forces would undoubtedly increase concentration and reduce competition within the insurance industry itself. The only effective way to prevent the anti-competitive forces involved in bank-insurnce transactions from adversely affecting the insurance marketplace is to separate sales of insurance from extensions of credit. Title VI of the Garn-St Germain Act represents a Congressional effort to bring about that result.

3. In the past you have argued that bank sales of insurance present the problem of tie-ins. Recently the U.S. Justice Department's Antitrust Division reviewed this issue and stated:

> **Participation by banking organizations in a broader range of financial activities would be unlikely to result in a significant increase in anticompetitive tying arrangements. The offering of two services or products as a package may represent an economically efficient means of conducting business. Absent market power, a firm cannot restrain competition by such a practice. Given the usual diversity of choices available to the financial services customer, it is generally unlikely that a particular provider of such services possesses the requisite market existing antitrust laws provide adequate protection against anticompetitive ties, whether undertaken by a banking organization, another type of supplier of financial services, or any other type of firm.**

How do you respond?

Despite many changes that have taken place within the financial services industry over the last decade, banks continue to be unique in terms of the role they play in our economy. For that reason, to view the relevant market in which bank-insurance

sales would take place as including other components of the larger financial service industry is unjustified.

Additionally, the Justice Department quotation advocates an unduly broad definition of "market power" in the context of bank-insurance sales. Because of the unique and pervasive function of banks in the economy, the concept of "market power" in respect of bank-insurance sales cannot be viewed broadly. When the average consumer or business goes to a bank seeking credit, few will be concerned about -- or even aware of -- the percent of deposits held by the bank in relation to other banks in the relevant marketplace. What the prospective borrower is concerned about is his ability to secure credit. If borrowers can enhance their chances of being successful in getting credit by purchasing additional services such as insurance from the bank, many consumers will do so. Those decisions are controlled, not by the "market power" of the bank in relation to other banks or other components of the financial services industry operating in the same marketplace, but by the level of desire of the individual consumer to secure credit and by the degree of interest of the bank in making an insurance sale. Whether insurance is tied to extensions of credit therefore is much more a function of the level of desire of the borrower to secure credit and the policies of management concerning how insurance is marketed than it is of other competitive forces within the marketplace.

4. On page 4 of your testimony, you state:

> **Bank holding companies are creatures of federal law and once any bank becomes affiliated with a bank holding company, Congress intended that the bank holding company would establish what is appropriate for bank holding companies, not the states.**

Are you suggesting that Congressional intent requires any state chartered bank which forms a holding company to divest any activity approved by the state but not approved by the Federal Reserve?

With the enactment of Bank Holding Company Act in 1956, Congress made the fundamental public policy decision to place limitations on the activities that can be pursued by entities that come to control banks. In making that decision, Congress did not sweep away all state participation in the regulation of bank holding companies and their subsidiaries. Through Section 7 of the BHC Act, Congress left to the states the authority to make laws affecting bank holding companies so long as those laws are more restrictive and not less restrictive than the BHC Act. See 12 U.S.C. § 1846 (1982).

Insofar as insurance is concerned, Section 4(c)(8) of the BHC Act as amended by Title VI of the Garn-St Germain Act does not represent an absolute bar to bank holding company insurance activities. The great majority of state banks that might choose to form themselves into bank holding companies would undoubtedly be relatively speaking small banks having total assets of $50 million. Because of the exceptions that Title VI has to the general insurance prohibition, it is likely that such entities would be able to form themselves into holding companies and still continue insurance agency operations initiated under state law.

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5. Given the economic pressure which exists for insurance companies to streamline the distribution system and lower distribution costs - other than closing the South Dakota loophole - what recommendations would you have for the Congress which would ease the transition to the financial services industry for insurance agents?

The insurance agency organizations have never recommended that Congress attempt to legislate the activities of the entire financial service industry. To the contrary, the insurance agent organizations have only asked Congress to recognize the potential adverse consequences of permitting large banking institutions which are regulated by federal law, the BHC Act, to engage in a broad range of insurance activities. Congress did that in 1982 when it enacted Title VI of the Garn-St Germain Act. The insurance agent organizations are now merely requesting that Congress comprehensively enforce the separation between banking and insurance that it legislated in 1982 by taking affirmative action along the lines of the Dodd Amendment to prevent circumvention of the law through bank holding company exploitation of a loophole that bank lawyers have proclaimed exists in current law.

6. Isn't it true that bank holding companies are merely registered with the Fed - they are not licensed or chartered by them?

Bank holding companies are chartered by the states, not the federal government. Nevertheless, under the BHC Act, bank holding companie are required to be registered with the Federal Reserve Board. The BHC Act imposes limitations upon bank holding companies with respect to the activities they may undertake. As a consequence, even though bank holding companies are corporate entities that are chartered by the states, the limits of their

activities are prescribed by Congress, not the various states that charter them.

7. If the record were to demonstrate that state chartered banks of holding companies have historically and are currently engaged in activities which have not been permitted by the Federal Reserve Board, would you then agree that the Bank Holding Company Act is intended only to specify the range of activities for subsidiaries of bank holding companies, not to limit the state granted authorities of state chartered banks?

The insurance agent organizations have consistently maintained that the BHC Act does not limit the authority of the states to empower state banks that are not affiliated with bank holding companies to engage in nonbanking activities. What the states may not do under the BHC Act is, through the enactment of state laws, enhance the authority of bank holding companies beyond what was intended by Congress as reflected in the BHC Act. The position of the insurance agent organizations is comprehensively set out in a November 21, 1984 petition which asked the Federal Reserve Board to repeal a regulation which authorizes bank holding companies to undertake through subsidiaries of state banks that are affiliated with holding companies any activity which state law authorizes the state bank to undertake directly. A copy of that petition is provided as Exhibit 3.

8. The Conference of State Bank Supervisors argues that the legislative history of the 1956 Bank Holding Company Act and its subsequent amendments of 1966, 1970, 1980, and 1982 is clear. The concept of the Act was to regulate bank holding companies and not their subsidiary banks. The passage of the Bank Holding Company Act or its amendments was not meant to override the dual banking system. Please find enclosed a copy of a letter from CSBS to the Federal Reserve Board and respond to each point raised in the letter.

While the BHC Act was not intended to override the dual banking system, the Act has always provided careful definit on of

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Exhibit 3: Available from the Senate Banking Committee files or from the Board of Governors of the Federal Reserve System, Nov. 21, 1984.

the relationship between itself and state banking laws. Specifically, Section 7 of the BHC Act has, since the date of the laws enactment, defined the preemptive effect of the BHC Act. Section 7 forbids the states from enacting laws affecting banks, bank holding companies and their subsidiaries which laws are less restrictive than the BHC Act. In that way, the BHC Act prevents the states from negating the effect of the BHC Act's limitations by establishing more permissive standards.

Far from interfering with the dual banking system, Section 7 of the BHC Act preserves that system. Without Section 7, the Supremacy Clause of the U.S. Constitution would deny the states any authority to enact any legislation affecting bank holding companies having standards different from the BHC Act. Moreover, the meaning of Section 7 of the BHC Act is not susceptible to reasonable dispute -- in Lewis v. BT Investment Managers, Inc., 447 U.S. 27 (1980), the Supreme Court said that Section 7 permits the states to enact laws affecting the components of bank holding companies which laws are more restrictive and not less restrictive than federal law thereby defeating the impact of the BHC Act.

The position of the insurance agent organizations concerning the role of the dual banking system in the bank holding company structure is set forth in a letter that responded to a Federal Reserve Board invitation for comments concerning the authority of the states to empower bank holding companies to engage through state-bank afffiliates in a broad range of real estate activities. A copy of that letter is provided as Exhibit 4.

Exhibit 4 & 5: Available from the Senate Banking Committee files or from the law firm of Charles, Karalekas, McCahill, & Wilson, Washington D.C.

Questions Posed by Senator Donald W. Riegle

1. In his testimony last week, Secretary Baker proposed that the Bank Holding Company Act be amended in order to give bank holding companies the authority to engage in activities "of a financial nature."

a. What would be the result of such an amendment?

It is the view of the insurance agent organizations that providing bank holding companies with the authority to engage in activities "of a financial nature" would significantly expand the current authority of the Federal Reserve Board to permit bank holding companies to enter upon a broader range of nonbanking activities. Giving the Board such new authority would almost certainly lead to a dramatic expansion of bank holding company nonbanking operations.

From the inception of our national banking laws, the business of banking has been statutorily separated from other forms of commerce. To date, no persuasive case has been made that the current relationship between banking and nonbanking activities needs to be altered significantly. For that reason, the broader authority that would be carried with the "of a financial nature" language advocated by Treasury Secretary Baker is not justified. The current "closely related" to banking standard set forth in the BHC Act provides ample flexibility to permit bank holding companies to pursue limited new nonbanking activities while, at the same time, preserving the longstanding separation between banking and commerce.

b. Do you support such an amendment?

For the reasons set forth in the response to 1.a., the insurance agent organizations do not support such an amendment.

2. The FDIC recently proposed regulations that would permit FDIC-insured banks to sell various kinds of insurance. The FDIC proposal would also permit banks to underwrite life insurance directly and to underwrite property and casualty insurance through subsidiaries.

a. What is your reaction to the FDIC proposal?

The insurance agent organizations believe the FDIC's proposed regulations that would permit FDIC-insured banks to undertake insurance agency activities and life insurance underwriting directly and property and casualty insurance underwriting through subsidiaries is unwise and entirely inconsistent with the longstanding principles which have required the separation of banking from commerce for more than 100 years. The position of the insurance agency organizations with respect to the FDIC proposals is more fully set forth in a letter provided by the insurance agent organizations to the FDIC commenting on the FDIC's proposals. A copy of that letter is provided as Exhibit 5.

b. What issues and concerns do you believe are raised by the FDIC proposal?

See Exhibit 5 referred to in the response to 2.a. above.

3. Concerns have been raised that the entry of banks into insurance agency activities may create the potential for tie-ins between credit and insurance products and may result in giving banks an unfair advantage in marketing insurance.

To what extent do you believe these concerns are valid and to what extent, if any, do you believe they are exaggerated?

The concern that the entry of banks into insurance agency activities would create the potential for tie-ins between the sales of insurance products and extensions of credit is fully justified and overwhelmingly documented in the public record. Exhibits 1 and 2 provided in response to these questions describe in detail how the relationship between a prospective borrower and

lender create an environment where tie-in sales of insurance can occur and provide an abundance of specific examples supporting the view that the concerns regarding tie-in sales of insurance in connection with extensions of credit are well justified.

4. It has been brought to my attention that property and casualty underwriters are beginning to face some real economic problems.

a. Are these reports accurate and, if so, how would you describe the present financial difficulties encountered by property and casualty underwriters?

It would be inappropriate for agents and brokers to question the credibility of their underwriters' own assessment of their financial condition. However, as we understand their situation, hard times have hit the property/casualty insurance underwriters, insurance capacity has been severely restricted in the marketplace, and insurance surplus has been called upon due to unexpected underwriting losses and a lower than expected return on insurer investment income.

b. In light of your assessment, how would you compare the riskiness of property and casualty underwriting to the normal business risk undertaken by a bank?

Property and casualty insurance underwriting involves the assumption of greater risk than the normal business risk undertaken by banks. When a bank makes a loans, the bank's total exposure is known in advance. Moreover, banks can limit risk by requiring an increased level of collateral or by other means. The risk exposure of property and casualty insurance underwriters is much more difficult to assess at the time insurance policies are sold. This is especially true in the current market. Evolving theories of insurance company liability and the increasingly

complex nature of the hazards covered by the property and casualty insurance industry have signficantly increased the riskiness of the property and casualty insurance industry over the last decade. For that reason, in the current environment, the property and casualty insurance underwriting business must be seen as significantly more risk-laden than normal banking operations.

5. I understand that Bank of America recently withdrew its application to acquire a South Dakota Bank that would have been empowered to sell insurance. The Federal Reserve Board had been considering whether such an acquisition is permitted by the Bank Holding Company Act.

In your view, what are the implications of Bank of America's actions?

As far as can be determined, BankAmerica has never fully explained its decision to withdraw its application to establish a South Dakota state bank for the purpose of circumventing the insurance limitations of Title VI of the Garn-St Germain Act. Nevertheless, BankAmerica's action probably had little to do with the legal and regulatory issues presented by its application. It is more likely that BankAmerica's decision was driven by its burgeoning financial problems. On July 17, 1985, for example, BankAmerica announced second quarter 1985 losses of $338 million. A copy of a July 18, 1985 American Banker article describing BankAmerica's financial difficulties is provided as Exhibit 6.

6. We know that banks are interested in engaging in the insurance business and there are indications that insurance companies are interested in the banking business. For example, Prudential recently announced its intent to offer home mortgage loans through its agents.

How do you respond to the argument that banks should be as free as insurance companies to expand their activities?

Exhibit 6: Available from the Senate Banking Committee files or from the American Banker, July 18, 1985.

The insurance agent organizations oppose the creation of circumstances where tie-in sales of insurance can occur, irrespective of how those opportunities might be created or the identity of corporate entities that might benefit from tie-in activities. The insurance agent organizations believe that bank holding companies should be prohibited from engaging in insurance activities in accordance with the limitations set forth in Title VI of the Garn-St Germain Act. Similarly, the insurance agent organizations oppose intrusions upon the banking business by all nonbanking enterprises, including insurance underwriters and securities firms.

7. This question is really unrelated to the subject of our hearing today, but I wonder whether you could take a minute to explain to us the effect on the insurance industry of the President's recent tax reform proposals?

Attached as Exhibit 7, you will find the written testimony of four of the six insurance agent organizations. Each goes into some detail on the effects of the President's tax reform proposal on the insurance industry. The written statements included are those of: Independent Insurance Agents of America, National Association of Casualty and Surety Agents, National Association of Life Underwriters, and National Association of Professional Insurance Agents.

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Exhibit 7: Available from the Senate Banking Committee files or from the House of Representatives, Committee on Ways & Means, Hearing of July 19, 1985.

The CHAIRMAN. Senator Dodd.

Senator DODD. Thank you very much, Mr. Chairman. As I'm sure the chairman may have noted, there are so many things going on here this morning, the briefing and so forth, I apologize personally for not being here to hear your statements, but I thank you for coming before the committee.

The CHAIRMAN. We talked about it while you were gone.

Senator DODD. I heard that my name came up several times.

I wonder if you might clarify something for me. As I understand it, I realize you're not necessarily experts in what occurred and has occurred in the last several months in Ohio and Maryland and so forth, but there is an assumption I've heard over and over again from people who are very inclined to support the whole notion of deregulation of powers that this occurred not exclusively—not exclusively and I don't mean to suggest they said it did—but it has occurred in no small measure because the institutions were overregulated, that in fact if we deregulated these institutions the likelihood that these problems would occur is less. In fact, it's been said that some people in your industry embrace that view.

As I understand what you're saying, it's not the question of whether or not there should be less regulation that has to do with the very nature of the powers themselves, but that if institutions can get into this kind of trouble with the powers they have that it would seem to indicate that there's at least a likelihood that with unlimited powers or at least significantly expanded powers there may be a greater likelihood of this kind of situation occurring.

Is that a correct assessment of your position, Mr. Carter?

Mr. CARTER. Basically yes, although you've got several issues tied together there.

REGULATION HAS PRODUCED MEDIOCRITY

I think that there are parts of the financial services industry over the years that have been so regulated as to produce mediocrity, particularly in the ranks of management. I think there's probably an example of that in the mutual life insurance industry, particularly in New York State. I would think the S&L's would be another such example. Starting maybe 10 years ago some people who saw the light first began to change that and 10 years later some people still haven't seen the light. So I think maybe the regulatory environment maybe did produce a piece of what occurred in Ohio and Maryland.

As for new powers, if you're having trouble doing your normal loan activity and you overextend in energy or placed your faith in the wrong people, you really ought to attend to that before you attempt to enter a new real estate business or a new life insurance business.

Mr. CROSBY. The insurance industry is not a highly profitable and a very risky industry as these industries go. I think any of the banking interests that have looked at insurance realize that they've got a very tough job ahead of them should they want to get into our ranks.

I would disagree with respect to overregulation if you were talking about the insurance industry. The primary factor we live with

in the States, Senator, is regulating for solvency and that is the primary obligation of those State insurance regulators. So long as they focus on that objective—and probably the same could be true for the S&L crises that have occurred in Ohio and Maryland and perhaps some other States that are now on the verge of it—I would disagree that we would be subject to overregulation.

We are concerned about the solvency of the insurance industry right now and any of these banking or financial services interests that want to get into insurance should likewise be concerned about that solvency.

We face that in Treasury II in the tax proposals addressing the insurance industry and we face it day in and day out at the State level.

Senator DODD. Let me ask you one additional question, the competitive equity question.

You have pointed out that with the closing of the nonbank bank loophole, of course, the insurance industry would be precluded from getting involved in banking. I realize it may be difficult to speak industrywide, but is it your assessment or your belief that if the nonbank bank loophole were closed, along with the South Dakota loophole, that the insurance industry would be willing to get out of the banking industry?

Mr. CARTER. Two levels of answer. As to the nonbank bank part of your question, I believe you would find all but a very few that would be willing to get out of the nonbank bank business. I have personally talked with several such owners and they were willing to go, including the biggest ones. A lot of that activity is defensive. We don't know where this is going, so if you get a shot at a nonbank bank you take it.

I would be inclined to do that myself, even though it's wrong ethically in its final form. It's something you almost have to do by default now.

Now a more complicated level of answer. There is a lot of overlap between banking and insurance activities and between what Citicorp and a large life insurance company do. But I think you would find in the life insurance industry a willingness to draw a line somewhere in there and to retreat back to that line whatever the costs. In some instances it would be a severe cost and in some it would be no cost.

Senator DODD. Mr. Crosby.

Mr. CROSBY. I do not think the trend toward financial deregulation, full financial services, or integrated financial services, whatever you want to call it, will cease and desist simply by closing the nonbank bank loophole or the South Dakota loophole.

As Senator Garn said earlier, financial services is coming. It's a matter of when. I can't say that our member companies will stop looking at banking affairs in the future simply by that action. Many of our member companies are engaged in one form or another of banking, subject to all the appropriate State and Federal laws, and will continue to do so.

Mr. CARTER. This is really a property and casualty panel and a life insurance panel.

Senator DODD. I'm fully aware of that.

Mr. CARTER. And the answers are very likely different.

Senator DODD. I assumed that.
Mr. Chairman, I thank you.

DRAMATIC CHANGE IN INSURANCE BUSINESS

The CHAIRMAN. Let me just ask one further question.

I mentioned earlier that I used to be in the life insurance business and I should have said that I would be totally unqualified to be in it today. The reason I say that—and I'm sure both of you agree—is that the insurance business has dramatically changed over the last 10 to 15 years. You were dealing with products that were considered outmoded by some and had to come up with a lot of new innovative products to be competitive, to stay in business, to try and provide your agent structure with the ability to compete with some of the same people the banks had to compete within the securities area and so on.

So in order to survive, you had to change rather dramatically. It really is a different business from what it was when you started out in it, John?

Mr. CARTER. Very much so.

The CHAIRMAN. Yet at the same time, forgetting the issues of this power against that power and who started it first and whether it was Don Regan or Merrill Lynch who started the whole mess or whatever, why do you assume—or maybe you don't—that banks should be held down to what they were doing 10, 15, 20, or 30 years ago and should have no opportunity to improve their product lines to stay competitive when that's exactly what the insurance business has had to do or you wouldn't be in business any more? You're not sending people around in the evenings to sell $5,000 family plans any more, or $5,000 life on the father, or $5,000 on the wife and kids any more, are you?

Mr. CARTER. Not as much as we did, no. But your point is well taken. We are a radically different business. I got out of the business as an agent about the same time you did and I would be most apprehensive to go back.

The CHAIRMAN. Yes, but you have been far more successful than I.

Mr. CARTER. You seem to have a better seat, Senator.

The CHAIRMAN. Well, I may have a better seat, but as we've offered some other witnesses, I'll trade you incomes.

Mr. CARTER. No deal. But you do have my vote, Senator. Let's get off that subject.

I am no authority on banking and I wouldn't pretend to be specific in my answer, but the general answer to your question is sure, they ought to be allowed to modernize or update or whatever the word should be and in fact, they have. But I don't think this makes it tenable for them to enter the insurance business.

The CHAIRMAN. Mr. Crosby.

Mr. CROSBY. We do think they should be permitted to diversify their product and service lines. We welcome their competition on a level playing field subject to the same regulatory powers that we are, and our companies that have looked at the prospects of bank competition say, "Come on in. We welcome you and as long as you're subject to the same laws, so be it."

The CHAIRMAN. Well, my bill last year closed the nonbank bank loophole, closed the South Dakota loophole, and allowed banks to deal in commercial paper, mortgage-backed securities, municipal revenue bonds, and discount brokerage. It had no real estate powers, or no insurance powers.

I would assume, on the basis of your answer just now then, that you would support S. 2851 in that form. Is that correct?

Mr. CARTER. We did support that bill last year, although there are provisions with which we disagree.

The CHAIRMAN. Mr. Crosby.

Mr. CROSBY. We would support it, Senator. The main thing——

The CHAIRMAN. As long as it doesn't have insurance powers in it, right?

Mr. CROSBY. We have tried to communicate that the rash of activity at the court level, in the States, and through other regulatory bodies trying to dictate where this is going to go in the near future. The main thing that everybody is calling for is for Congress to act, and I know you have heard that message loud and clear.

The CHAIRMAN. I've been yelling for years and years.

Mr. CROSBY. And if our support will help that take place, you've got it.

The CHAIRMAN. So you would both agree that it would make a great deal more sense for Congress to own up to our responsibilities rather than allowing the courts, the regulators, and the State legislatures to define what this system is that is changing out there?

Mr. CROSBY. By all means.

The CHAIRMAN. Gentlemen, thank you very much for your willingness to testify. But before we begin, Senator Mattingly has a brief statement for the record.

Senator Mattingly.

Senator MATTINGLY. Mr. Chairman, I would like to welcome to the Senate Banking Committee Bill Huntley from Atlanta, GA. Bill is an account executive and vice president with Pritchard and Jerden in Atlanta. He appears before the committee today in the capacity of director and chairman of the legislative committee for the National Association of Casualty and Surety Agents, and will present testimony on behalf of the Insurance Producer Coalition.

Thank you Mr. Chairman.

The CHAIRMAN. Now I'd like to invite to the witness table panel No. 3, Mr. William B. Huntley, Richard G. Taylor, Joseph H. Dimond, Kirk R. Englehardt, David L. Ream, and George T. Moran.

Mr. Huntley, I understand you have been chosen and designated, after arm wrestling and twisting, and so on, to be the spokesman for this group.

Mr. HUNTLEY. That's absolutely correct.

STATEMENT OF WILLIAM T. HUNTLEY III, CPCU, PRITCHARD & JERDEN, ATLANTA, GA, DIRECTOR AND CHAIRMAN, LEGISLATIVE COMMITTEE, NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS, ACCOMPANIED BY RICHARD G. TAYLOR, PRESIDENT-ELECT, INDEPENDENT INSURANCE AGENTS OF AMERICA; JOSEPH H. DIMOND, ON BEHALF OF THE NATIONAL ASSOCIATION OF INSURANCE BROKERS; KIRK R. ENGLEHARDT, MEMBER, FEDERAL LAW AND LEGISLATION COMMITTEE, NATIONAL ASSOCIATION OF LIFE UNDERWRITERS; DAVID L. REAM, VICE PRESIDENT, NATIONAL ASSOCIATION OF PROFESSONAL INSURANCE AGENTS; AND GEORGE T. MORAN, REGIONAL VICE PRESIDENT, NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS

Mr. HUNTLEY. Thank you, Mr. Chairman.

My name is William T. Huntley III, and I am with the insurance brokerage firm of Pritchard & Jerden of Atlanta, GA. I am here today as a member of the National Association of Casualty and Surety Agents, of which I am a director and the current chairman of the association's legislative committee. I am speaking this morning on behalf of all of the national insurance producer trade groups represented here today on this panel. My distinguished colleagues with me on this panel are Richard G. Taylor, Salt Lake City, UT; Joseph H. Dimond, Detroit, MI; Kirk R. Englehardt, Salt Lake City, David L. Ream, Cleveland, OH; and George T. Moran, Severna Park, MD.

Mr. Chairman, this panel represents the majority of the insurance producer community which sells and distributes insurance products throughout the United States.

This is not in my oral testimony, but I did pick upon a word that you mentioned and it was "frustrated," and I guarantee you if we weren't frustated we wouldn't be here today. So we share that with you.

We would request that written statements of the groups represented on the panel be made a part of the formal hearing record of this committee.

The CHAIRMAN. They will be.

Mr. HUNTLEY. Thank you.

Mr. Chairman, the topic of your oversight hearings is "Changes in the Financial Services Industry." If we may, we would first like to review what has not changed and then focus our attention on changes that have occurred in the financial services marketplace.

PRINCIPLE CONCERNING TITLE VI

The CHAIRMAN. Mr. Huntley, we are just going to have to agree to disagree because most of your testimony I agree with. It's the correct recitation of the facts and I think I do understand title VI. I stood before the ABA 2 days before the bill was passed, who said they wanted to kill the bill because it was in there and they would do so. If they wanted to throw the baby out with the bathwater I think it is fair to say that I carried the ball on that whole bill almost singlehandedly toward the end of it or over the last couple days. So I don't really need to be lectured on what title VI says.

The rest of your testimony is well written by your attorney. Being a nonattorney, I have to listen to attorney talk here day after day after day, splitting hairs, and I can agree with them that they are technically correct. I can listen to them recite what the intent of the Bank Holding Company Act was and title VI, and you can hide behind that. I don't mean this disrespectfully—Dick has known me long enough and he's a long-term friend and we've talked about this a great deal. He knows how strongly I feel about the principle and, as I said before, I am not going to repeat my whole speech. I don't suppose I would feel this way if I hadn't been part of the industry for as long as I was, feeling that independence and willingness to compete against anybody. Maybe that's just my own personality. I wouldn't be in politics I guess if I wasn't a competitor.

But the practical effect is, whether you can cite legal precedent or not, that it is a violation of a State legislature's right to make a determination for a State-chartered institution. Where you're splitting hairs you're saying but if it's owned by an out-of-State bank or even an in-State bank-holding company, we're taking that right away. And I don't understand why you wanted to go with that override.

My original amendment that was proposed before Chris offered his closed interstate and it closed it tight. There was no doubt about that. There was no dispute about it.

The practical effect of going one step further and tromping on that principle, whether legally I can prove that or not, isn't the point. You live in the real world. You sell insurance. You know what I'm talking about. But it has no practical effect to take that one more step.

Do you think that Citicorp is going to want a State-chartered institution in the State of South Dakota to sell insurance just within the State of South Dakota, or any of the others? Do you think there would be a rush of bank holding companies, if we had adopted my original amendment to cut it off, into South Dakota, or Utah, or any of the other small States in this country? That's what I don't understand. Even if I accepted every bit of your testimony and said you were right, here we are, insurance agents of this country, normally conservative, fierce competitors, independent, willing to go out and make their sales pitch and try to get the business. I've asked most everybody, including Dick, if he was willing to go and fight the State legislature. Most of my people originally at home felt that this meant, if the Dodd amendment did not pass that that would automatically authorize banks to sell insurance. All it said is that the State legislature can make that decision. I'm sure Dick and others like Kirk Englehardt would be leading the charge up to our State capital saying, "No, no, we don't want this." That's where I'm coming from.

Why do you want to fight so hard for something that, at least in my opinion, practically tromps on States rights, the rights of your legislatures in your States that you deal with for your insurance matters, your filings and all your insurance laws in the State. You're perfectly willing to go up and deal with them on that, but you don't want the Feds to supersede some of those. In this case I think you have been trapped by that New York situation. I really

do. I think that's the genesis of this, where it came from. The New York insurance people didn't want to worry about doing it in the New York Legislature. So you get a friend upset, but not personally. Dick and I and others have no problems personally and Chris and I don't. We're as good of friends as exist in the Senate. That's why we kid each other so much. There is no one I admire more. We disagree on the issue. So it isn't personal animosity I have. It's irritation over a principle.

You just agreed with me, and I'm sure all of you would, that Citicorp has no interest in South Dakota if they can't export it across State lines. That's the only reason they created the loophole. That clearly was not the intent of title VI, no doubt about it. There's not a bit of disagreement on that at all, and that shouldn't be allowed to any State to export services of any kind across their State lines. Like I said, we weren't even allowed to propose a compromise that would allow bank holding companies inside a State to do that, forget the Citicorps and the out-of-State bank holding companies. I have never seen an issue so built up and it's something that has practically no practical effect at all. I really don't think it does. I don't know of any bank holding company that would rush into a State like South Dakota, which is even smaller than Utah. And the unwillingness—I haven't heard the unwillingness, not from my insurance agents, my old friends, and I know them much more intimately than I normally would as a Senator because I used to compete with many of them. Not one of them has told me they were unwilling to go up and fight the Utah Legislature over powers, whether it was that free-standing State-chartered bank or whether they happened to be owned by an out-of-State bank holding company. They were willing to take on that flack.

So I'm not sure I really understand the argument and why there's been such a monumental push. I understand why Chris offered it and I respect him for that. We have no disagreement, as I said. But I have never felt so strongly that we have gone too far, and I realize that's part of my own bias from my being part of the industry, but I really do think it's a mistake.

I don't have any questions. I'm sure Chris does.

Mr. Huntley, did you wish to respond?

Mr. HUNTLEY. Yes, Mr. Chairman.

NEED FOR CHANGE IN FEDERAL STATUTE

One point I'd like to make is this, as I understand title VI, if we allow Citicorp to buy this State-chartered South Dakota bank, then in effect that particular bank should come under the jurisdiction of the Federal law as it now exists under the act. I think if we're going to allow Citicorp to do that, if you want banks to get into the insurance business and that's what Citicorp wants them to do, I think we've got to go back and amend title VI to allow banks in the insurance business. I am not recommending that. I wouldn't even hint at doing that. But you have got to do that if you want them to do what they are trying to accomplish in South Dakota.

The CHAIRMAN. No, I don't.

Mr. HUNTLEY. It's got to be in the Federal statute right now.

The CHAIRMAN. I don't agree with that. You're getting back to the attorneys now and Citicorp isn't even going to be interested if you close the loophole the way we originally did. They are not going to care about going into South Dakota.

Mr. HUNTLEY. I understand that, but I say if they want to get into the business they've got to change the law as it stands.

Senator DODD. Mr. Huntley, let me if I can, Mr. Chairman, because we have discussed this. I feel like Sisyphus in some ways, constantly rolling the rock up to the top of the hill for the rest of my life. But aside from that it was a very articulate statement, excellent statement, very clear statement, about the Bank Holding Company Act, and I think it's an important statement to make. I don't care who wrote it.

The CHAIRMAN. That's because you're an attorney.

Senator DODD. It was a very excellent statement, a very clear statement.

I don't have any doubt either about Citicorp going into South Dakota. I think they might like to go into California, Texas, and a few other places because that's where the bulk of the insurance business is. I forget the statistics on it, but that's the lion's share of the industry. It's not going to wander around in small States, but they will go into those States where there's a tremendous piece of the action. It's not equally distributed, the action.

The CHAIRMAN. If the State legislature—now you're getting back to my major hangup over that, if the State legislature will allow them. If the California State Legislature allows them to do that, that's the California State Legislature's business, not mine to impose that on California.

Senator DODD. You and I have no disagreement on that point because, as I've said over and over again, we've cleared it with State-chartered institutions. That's the battle. I'm surprised they haven't. But they've decided not to engage in that battle. They could have done that. Why is it they want to go in and change the Bank Holding Company Act? I don't think you're asking that question. If they're so interested in getting into this business, why don't they go into these States? Why haven't they gone into California and asked the State legislature in California to allow State-chartered banks to sell insurance?

The CHAIRMAN. They probably can't win it.

Senator DODD. Well, I don't know.

Mr. HUNTLEY. May I interrupt 1 second, Mr. Chairman?

The CHAIRMAN. Go ahead.

Mr. HUNTLEY. There have been court cases in the State of Georgia that have impacted on the Federal outlook on insurance, as you well know, and I needn't cite the first Atlanta case, however, we have been fighting in Georgia year in and year out and every Tom, Dick, and Harry has tried to get in our business down there who's in the banking business, and we have been very successful in keeping them out.

We foresee Citicorp in South Dakota, then they've got Georgia, Alabama, Florida, and the rest of them.

Senator DODD. I don't have any questions either because we've been down this road many times, but I think your statement is very worthwhile and let me just echo what the chairman said as

well. I am anxious for us to get a bill here. I think the insurance community is as well. The chairman has been extremely gracious and patient over the last several years on these issues. There are a lot of other people who would react rather differently with a battle over an issue like this, which he has some slight emotions about, and to his credit he marches forward, and I think it was very unfortunate last year that we didn't get it passed and we're back here doing it all over again on the House side. So my hope would be that we will see what the chairman wants and proposes in this area, but then I would hope that the industry would really get behind and push support for the legislation. We really need your help.

Mr. Chairman, there's no secret that these people at the table represent some people that did some incredible work nationwide in getting in touch with their Members of Congress and so forth. If you reactivate that juggernaut which was tremendously successful last year in getting people interested in this issue to back the piece of legislation we come out of the Senate with, I think we could pass the bill and I think that would be helpful.

I thank you.

LIMITED BILL IS NOT SUFFICIENT

The CHAIRMAN. Well, on that, Senator Dodd and I agree. A limited bill closing a couple of loopholes, as you have heard over and over again today, in my opinion, is not sufficient, and the other issues in the bill you have no quarrel with. It is not some vast deregulation bill. As I reiterated earlier, it only allows two new powers—municipal revenue bonds and mortgage-backed securities—to banks which I don't think too many people would disagree are certainly financially related. They have sold general obligation bonds for years and years.

I have no more questions but I would like to hear from any of those of you who have not had an opportunity to answer questions or any statements you would like to make.

Mr. TAYLOR. Well, Mr. Chairman, let me just simply say that you have paid me a compliment earlier today and I would just like to return that.

We don't agree on some of the issues, but we certainly do agree that you represent Utah very well and I'm proud to have you here.

On this particular issue, I guess we just feel, Mr. Chairman, that Congress made its decision early as to the behavior that they expected from bank holding companies. We feel that that decision should be either upheld or Congress should change the rule. The loophole that Citicorp came into South Dakota with, we wouldn't be here discussing the Dodd amendment had they not proposed that loophole. Other than that, I think we have expressed to you on several occasions that at least as far as the independent insurance agents are concerned we support your legislation. We will help you pass your bill, but we feel that that is an area that we just have to have some assistance on.

The CHAIRMAN. Would you also agree, though, that the difference in the Dodd amendment and the original closer of the South

Dakota loophole really has no practical effect on what bank holding companies like Citicorp would do?

Mr. TAYLOR. I think that they would take advantage of it. I think we have to have that or it will affect their thinking and their action.

The CHAIRMAN. Well, do you really think they would come to Utah, as an example, and get a State-chartered institution just to sell insurance in Utah?

Mr. TAYLOR. They may not come to Utah, Senator, but I think Senator Dodd expressed that pretty well—they may not come to Utah, but we are representing a much broader membership and I think they will go other places.

The CHAIRMAN. Well, take California. That gets back to my point again that California insurance agents are willing to go up and fight their legislature on that issue?

Mr. TAYLOR. There is no question about it. They would do that.

The CHAIRMAN. Getting back to the bottom line, we don't disagree on the substance of the issue. That is not the problem. It is the method of solving that issue. If I were still in Utah, or California, or wherever, I wouldn't have any trouble lobbying my legislature to say, "Hey, I don't like what you're doing and I'm not going to vote for you next time if you vote for that."

Mr. TAYLOR. I understand.

The CHAIRMAN. I just want you all to understand fully where I'm coming from and why I feel strongly about the issue. It's not the substance because we agree on it. It's the method and whether we went one step too far or not.

Mr. Dimond, do you have any comments you wish to make?

Mr. DIMOND. Only, Mr. Chairman, that in several States we, the independent insurance agents particularly, have been fighting in the legislatures and in the courts. Michigan is a typical example. Just recently we got a ruling from the insurance commissioner denying an insurance agent license to a subsidiary of Detroit Savings & Loan on the premise that it violated the privacy of information portion of the insurance code. It also held such an arrangement would open the door completely to coercion on the part of the lending institution. There were other points, too, but those were the two principal ones. We have been at this for approximately 2 years, and we've spent something over $100,000 of our members' money fighting bank entry into insurance. We're not finished yet. It looks like it's going on for another year or two.

The CHAIRMAN. Would you agree that banks should stay out of the insurance business and insurance companies should stay out of the banking business?

Mr. DIMOND. I don't see any reason why insurance companies should go into the banking business, and I certainly do not think it's in the best interest of the public for the banks to be in the insurance business.

The CHAIRMAN. Kirk.

Mr. ENGLEHARDT. My only comment, Mr. Chairman, would be, as you may know, I had the opportunity to lobby on the State level as well as on the national level, and I would personally hate to go before our Utah State Legislature against Citicorp. With our limited resources of life underwriters, I would have a very difficult time

stating my case, putting resource against resource. Therefore, I would like to see this battle fought where it's appropriately fought, here.

The CHAIRMAN. Well, of course, we disagree on the appropriate battleground, but I would also disagree with you on whether you would win there. I think that would be one of the easier lobbying jobs that you could have. Knowing the legislature very well, I would be very, very surprised if you didn't win that one easily. Dick, wouldn't you agree?

Mr. TAYLOR. I guess I have to disagree with my colleague on that. I think if we got a coalition together we could prevail there. But I do agree with the second part of his statement.

The CHAIRMAN. I don't think you would even need any money.

Mr. TAYLOR. You told me that you would come and help us, so——

The CHAIRMAN. Just turn a few of our friends loose for a couple of days and that would take care of that.

Mr. Ream.

Mr. REAM. Thank you, Senator.

PROPER FORUM FOR DEBATING THE ISSUE

I have to agree with my colleague, Kirk, here that this is the proper forum to be debating this issue as to whether we need or do not need the Dodd amendment, simply because we are talking about Federal regulation.

And to impose upon the insurance industry the necessity of going to the various 50 States to argue this case where we have the mechanism in place in the Federal Government or through the Federal laws here in title VI, I think it's inappropriate that we would have to go out and make this type of effort.

The CHAIRMAN. Why should you have to have your companies file before every State then? On that logic, then insurance companies would be far better off in just having one set of rules for all 50 States.

Mr. REAM. Because the mechanism is in place here, Senator. We have a creation of the Federal Government that is regulated by the Federal Government, and so this is the proper forum to be discussing the regulation of bank holding companies.

The CHAIRMAN. You're correct. It's the proper forum for discussing it, but you can make the same case for it. There's a lot of people who want the FTC to get involved in insurance.

Mr. REAM. The State-chartered banks that are regulated by the States have the authority to do whatever the States entitle them to do, and that's fine. We may not like it, but it's something that we live with.

But we are talking here about federally chartered bank holding companies that are regulated by Federal law, and that's why we feel this is the proper forum.

We also feel——

The CHAIRMAN. Correction. They are not federally chartered. They are State chartered. They are federally regulated.

Mr. REAM. Federally regulated. They freely choose to come under the Bank Holding Company Act. This is a choice they make for

whatever reasons, be they for taxing reasons or branch banking reasons or whatever reasons, they freely choose to become a bank holding company and, therefore, they have freely chosen to subject themselves to Federal regulations that we have in place through title VI.

And I think it is only the very creative minds of some New York attorneys that have found this South Dakota loophole. This has been confirmed most recently by the Eleventh Circuit Court of Appeals. If you read the conference committee report, both the House and Senate when they discussed title VI, said——

The CHAIRMAN. I was a part of the conference.

Mr. REAM. I understand that, Senator. In any event, I think that what we need to do here is to keep it in the proper forum and we believe that this is the proper forum, Senator.

The concern of professional insurance agents is more concerned, though, with the entrance of banks into the insurance business because of the leverage that they have over the consumer. The consumer right now purchases insurance based on his perception of price, product, and service. We feel this best serves the consumer in the long run and he is able to make an intelligent insurance decision.

There is no lack of competition, as you've admitted, in our business. There are many, many insurance companies and there are thousands of local insurance agents. So we are not lacking for competition within our business. And if the competition is on the level playing field, there is no problem with insurance agents. We are used to competition. But it's when you throw in the credit leverage that competition is no longer on a level playing field and we don't feel this serves the public.

The CHAIRMAN. Mr. Moran.

Mr. MORAN. There's really nothing more I could add that hasn't already been stated.

The CHAIRMAN. Let me just say that I hope that this selective interpretation of what is States right and what isn't States rights doesn't come back to bite you some day on some other issue. Maybe I wouldn't feel this way, although Dick particularly knows that my feelings over the years before I ever got involved in politics once I decided were rather strong, and I was one who liked to stick to certain principles. I really believe even if I wasn't in this position that I would not be joining my fellow insurance agents in lobbying to go that one step further because I was very active in politics before I ever got entrapped into running for public office myself, and maybe I'm looking at it in hindsight, but I really feel I would not be supporting your position to go that one step further in the Dodd amendment if I were still back as one of you.

Mr. TAYLOR. I think that's probably true. You have always made your feelings known and you have stuck to them whether you were a Senator, or a mayor, or an insurance agent. I think that's very true. And we have had to weigh these issues under McCarran-Ferguson and the States rights issue, Senator, but we really feel strongly that we are right on this issue and I guess just as strongly that we are wrong, and if that comes back at a later date in McCarran-Ferguson we're just going to have to face it at that time

and I think we can be as convincing that we are correct at that time.

The CHAIRMAN. I didn't mean necessarily just McCarran-Ferguson. There are a lot of States rights that I feel have been trampled on. I have always been consistent, too, in banking legislation that has nothing to do with you. I have always been one who insisted on what came to be known as Garn amendments to overrides, even when we felt it was unnecessary. One such time was preempting the State usury ceilings when we had situations like Arkansas with a 10-percent usury ceiling constitutionally established. The Senators from that State asked us to preempt when many other States were having 15 to 16 percent interest and you were killing these States. We had a preemption, but I still insisted on a minimum of a 3-year override for a State to say, "Hey, we don't agree with that. We love our 10 percent and we want to keep it."

So on many other issues other than this I have been very, very consistent in the right of States to do something even when I felt we should preempt, still giving them the opportunity to opt out.

I appreciate your willingness to testify and particularly stay through the lunch hour. Thank you very much for coming.

Mr. TAYLOR. We appreciate you staying with us. Thank you, Senator.

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 1:15 p.m., the hearing was adjourned.]

[The complete prepared statements and response to written questions of Senators Garn and Riegle follow:]

ORAL TESTIMONY OF THE

INSURANCE PRODUCER COALITION*

PRESENTED BEFORE

THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

BY

WILLIAM T. HUNTLEY, III, CPCU

DIRECTOR, NATIONAL ASSOCIATION OF CASUALTY & SURETY AGENTS

ON

WEDNESDAY, JUNE 19, 1985

*Independent Insurance Agents of America
National Association of Casualty & Surety Agents
National Association of Insurance Brokers
National Association of Life Underwriters
National Association of Professional Insurance Agents
National Association of Surety Bond Producers

THANK YOU, MR. CHAIRMAN, AND GOOD MORNING. MY NAME IS WILLIAM T. HUNTLEY, III. I AM A CHARTERED PROPERTY AND CASUALTY UNDERWRITER WITH THE INSURANCE BROKERAGE FIRM OF PRITCHARD AND JERDEN OF ATLANTA, GEORGIA. I AM HERE TODAY AS A MEMBER OF THE NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS (NACSA), OF WHICH I AM A DIRECTOR AND THE CURRENT CHAIRMAN OF THE ASSOCIATION'S LEGISLATIVE COMMITTEE. I AM SPEAKING THIS MORNING ON BEHALF OF ALL OF THE NATIONAL INSURANCE PRODUCER TRADE GROUPS REPRESENTED HERE TODAY ON THIS PANEL. TO MY RIGHT ARE: RICHARD G. TAYLOR, GRANT HATCH & ASSOCIATES, INC., SALT LAKE CITY, UTAH, PRESIDENT-ELECT OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA (IIAA); AND JOSEPH H. DIMOND, DETROIT, MICHIGAN, SR. V.P., FRANK B. HALL & CO. OF MICHIGAN. REPRESENTING THE NATIONAL ASSOCIATION OF INSURANCE BROKERS (NAIB). TO MY LEFT ARE: KIRK R. ENGLEHARDT, BUSINESSMANS PLANNING, SALT LAKE CITY, UTAH, A MEMBER OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITER'S (NALU) FEDERAL LAW AND LEGISLATION COMMITTEE; DAVID L. REAM, CIC, CPIA, PRESIDENT OF L.F. REAM, INC., CLEVELAND, OHIO, A VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS (PIA), AND

THE CHAIRMAN OF PIA'S GOVERNMENT AFFAIRS COMMITTEE; AND GEORGE T. MORAN, GEORGE T. MORAN, INC., SEVERNA PARK, MARYLAND, A REGIONAL VICE PRESIDENT OF THE NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS (NASBP).

MR. CHAIRMAN, THIS PANEL REPRESENTS THE MAJORITY OF THE INSURANCE PRODUCER COMMUNITY WHICH SELLS AND DISTRIBUTES INSURANCE PRODUCTS THROUGHOUT THE UNITED STATES.

WE APPRECIATE HAVING THIS OPPORTUNITY TO APPEAR BEFORE THIS DISTINGUISHED SENATE COMMITTEE TO EXPRESS THE VIEWS OF THE INSURANCE PRODUCER DURING YOUR OVERSIGHT HEARINGS ON THE "CHANGES IN THE FINANCIAL SERVICES INDUSTRY."

OUR INTENTION, MR. CHAIRMAN, IS TO MAKE OUR ORAL REMARKS BRIEF. HOWEVER, WE WOULD REQUEST THAT ANY WRITTEN STATEMENTS OF THE GROUPS REPRESENTED ON THE PANEL BE MADE A PART OF THE FORMAL HEARING RECORD OF THIS COMMITTEE. THANK YOU.

MR. CHAIRMAN, THE TOPIC OF YOUR OVERSIGHT HEARINGS IS "CHANGES IN THE FINANCIAL SERVICES INDUSTRY." IF WE MAY, WE WOULD FIRST LIKE TO REVIEW WHAT HAS NOT CHANGED AND THEN FOCUS OUR ATTENTION ON CHANGES THAT HAVE OCCURRED IN THE FINANCIAL SERVICES MARKETPLACE.

WE BELIEVE, MR. CHAIRMAN, THAT SOME IN CONGRESS HAVE BECOME TOO PREOCCUPIED WITH THE NEW DEVELOPMENTS. AS A CONSEQUENCE, LONGSTANDING CONVENTION AND VALID INTENDED PURPOSES OF CURRENT LAW ARE SET ASIDE AND MORE OFTEN THAN NOT, ARE NOT BROUGHT BACK INTO FOCUS.

MR. CHAIRMAN, WHAT APPEARS TO US TO REMAIN UNCHANGED, AND IS IN OUR VIEW OVERWHELMINGLY SIGNIFICANT, IS THE INTENT AND PURPOSE OF THE BANK HOLDING COMPANY ACT OF 1956, AS AMENDED, IN ALL OF ITS PARTS, INCLUDING, OF COURSE, THE TITLE VI INSURANCE RESTRICTIONS OF THE GARN-ST GERMAIN ACT OF 1982. BOTH THE EXPRESS AND IMPLICIT INTENT OF THIS FEDERAL BANKING STATUTE REMAIN INTACT AND ARE THE KEY INGREDIENTS IN THE DEBATE OVER THE "SOUTH DAKOTA" STATE-CHARTERED BANK LOOPHOLE IN THE BHCA.

As you know, Mr. Chairman, in 1956, the Congress enacted the BHCA to establish a federal regulatory scheme for BHCs which would promote and preserve a safe and sound national banking system, prevent conflicts of interest and unfair competition, and avoid undue concentration of economic power. These goals continue to be the major objectives of the BHCA today.

BHCs are creatures of federal law, and it is that federal law which determines, and has always determined, what are appropriate activities for BHCs. In 1956, the Congress established under the BHCA the parameters of national bank policy and the regulatory structure for BHCs. We believe, Mr. Chairman, what was true in 1956 is true today; the BHCA is a seamless statutory fabric designed by Congress to accomplish a specific and clearly defined purpose.

Taking the Act's legislative history a step further, in 1982, the Congress, through the enactment of Title VI of the Garn-St Germain Act, expressly limited the insurance activities of BHCs. The statute, as amended in 1982, was and is intended to apply to all parts of the

HOLDING COMPANY, ITS BANKING AND NON-BANKING SUBSIDIARIES ALIKE. TO QUOTE THE HOUSE CONFERENCE REPORT TO THE 1982 AMENDMENTS:

> THE SENATE AMENDMENT GENERALLY PROHIBITS BANK HOLDING COMPANIES AND THEIR SUBSIDIARIES FROM PROVIDING INSURANCE, INCLUDING PROPERTY AND CASUALTY INSURANCE PRODUCTS, AS A PRINCIPAL, AGENT, OR BROKER, WITH SIX SPECIFIC EXCEPTIONS ENUMERATED IN THE TITLE. (HOUSE REPORT No. 97-899, P. 91)

THE SENATE REPORT IN 1982 STATES THE FOLLOWING AS THE INTENT OF TITLE VI:

> DURING THE PAST SEVERAL YEARS, THE COMMITTEE HAS HELD A NUMBER OF HEARINGS ON LEGISLATION DESIGNED TO RESTRICT THE INSURANCE ACTIVITIES OF BANK HOLDING COMPANIES. THE BASIC THRUST OF SUCH LEGISLATION HAS BEEN TO PROHIBIT BANK HOLDING COMPANIES FROM SELLING OR UNDERWRITING

PROPERTY AND CASUALTY INSURANCE. (SENATE REPORT No. 97-536, P. 37)

THE BHCA FOCUSES ON THE ACTIVITY OF SELLING INSURANCE AND CONCLUDES THAT THE SALE OF INSURANCE IS NOT "CLOSELY RELATED" TO BANKING. THE ACT'S PROHIBITION APPLIES WITHOUT REGARD TO THE CORPORATE STRUCTURE THAT A BHC MAY ATTEMPT TO USE TO ENGAGE IN NON-BANKING ACTIVITIES.

AS RECENTLY AS MAY 20, 1985, THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT IN ITS U.S. TRUST DECISION MADE CLEAR THAT THE SECTIONS OF THE BHCA MUST NOT BE READ IN ISOLATION, AND LITERALISM SHOULD NOT JUSTIFY SETTING ASIDE THE EXPRESS INTENT OF CONGRESS. IN FACT, THE COURT HELD ON THIS ISSUE OF NON-BANK BANKS:

> [A]CTIVITIES APPROVED AS CLOSELY RELATED TO BANKING HAVE BEEN THE ACQUISITION OF BROKERAGE SERVICES OR THE OFFERING OF CREDIT LIFE INSURANCE, NOT THE WHOLESALE ABANDONMENT OF ONE OF CONGRESS' CHIEF GOALS IN ENACTING THE BANK HOLDING COMPANY

ACT. (FLORIDA DEPT. OF BANKING AND FINANCE V. BOARD OF GOVERNORS, NOS. 84-3269, 84-3270 (11TH CIR. MAY 20, 1985))

MR. CHAIRMAN, WE SUBMIT THAT WHAT HAS NOT CHANGED IS THE VERY FIBER OF THE BHCA - ITS INTENT AND PURPOSE. BHCS ARE CREATURES OF FEDERAL LAW AND THEIR ACTIVITIES ARE PRESCRIBED BY CONGRESS IN THE BHCA. THE BHCA IS INTENDED TO KEEP BANKING SEPARATED FROM COMMERCE, EXCEPT IN THOSE SPECIFIC SITUATIONS EXPRESSLY IDENTIFIED BY CONGRESS IN THE STATUTE. THE RESTRICTIONS OF THE ACT ARE INTENDED TO APPLY TO THE HOLDING COMPANY AND ALL OF ITS PARTS. TO INTERPRET THE ACT'S INTENT TO BE OTHERWISE IS, IN OUR OPINION, TO PUT INTO JEOPARDY THE ACT IN ITS ENTIRETY, NULLIFYING IT PIECE BY PIECE.

NOW TO WHAT HAS CHANGED -

THE INK OF THE GARN-ST GERMAIN ACT WAS BARELY DRY BEFORE CITICORP AND SEVERAL OTHER LARGE BHCS WENT OUT TO SOUTH DAKOTA TO PERSUADE ITS STATE LEGISLATORS AND GOVERNOR TO ENACT STATE ENABLING LEGISLATION EXPANDING THE INSURANCE POWERS OF SOUTH DAKOTA STATE-CHARTERED BANKS.

THE GIMMICK - CITICORP AND THE OTHER BHCS WOULD BRING JOBS TO SOUTH DAKOTA. HOW? THE BHCS WERE ABLE TO CONVINCE THE SOUTH DAKOTA LEGISLATURE THAT THE TITLE VI INSURANCE RESTRICTIONS OF THE BHCA ONLY APPLIED TO THE NON-BANKING SUBSIDIARIES OF THE HOLDING COMPANY. THUS, NOTHING IN THE BHCA COULD PRECLUDE BHCS FROM ENTERING THE INSURANCE BUSINESS IN SOUTH DAKOTA AND NATIONWIDE THROUGH THE ACQUISITION OF SOUTH DAKOTA STATE-CHARTERED BANKS. IN PURSUIT OF NEW JOBS, SOUTH DAKOTA ENACTED NEW STATE BANKING LEGISLATION IN MARCH 1983. THE NEW LAW AUTHORIZED SOUTH DAKOTA BANKS TO ENGAGE IN "ALL FACETS OF THE INSURANCE BUSINESS" AND PERMITTED SOUTH DAKOTA BANKS TO BE ACQUIRED BY OUT-OF-STATE BHCS. THEREAFTER, CITICORP, FIRST INTERSTATE BANCORP AND BANK OF AMERICA ALL APPLIED TO THE FEDERAL RESERVE BOARD UNDER SECTION 3 OF THE BHCA TO ACQUIRE SOUTH DAKOTA STATE-CHARTERED BANKS FOR THE EXPRESS PURPOSE OF OFFERING A BROAD RANGE OF INSURANCE SERVICES. THUS, UPON APPLICATION, THE "ALLEGED" "SOUTH DAKOTA" LOOPHOLE WAS BORN. THESE BHCS DECLARED TO THE FEDERAL RESERVE BOARD THAT SINCE SECTION 4(C)(8) RESTRICTIONS OF THE BHCA DID NOT APPLY TO BHC BANK SUBSIDIARIES, BHCS COULD, THROUGH

STATE-CHARTERED BANK SUBSIDIARIES, DO WHAT WOULD BE OTHERWISE PROHIBITED TO THEM THROUGH A NON-BANKING SUBSIDIARY.

ALTHOUGH FIRST INTERSTATE BANCORP AND BANK OF AMERICA (6-10-85) HAVE SINCE WITHDRAWN THEIR APPLICATIONS, CITICORP'S APPLICATION IS ACTIVELY PENDING BEFORE THE BOARD.

IT IS OUR OPINION, MR. CHAIRMAN, THAT WHAT HAS CHANGED IN THE MARKETPLACE IS A MOVEMENT TOWARD LOOPHOLE SHOPPING. AND MORE IMPORTANTLY, THE BHCs' INTERPRETATION OF THE BHCA's SECTION 4(c)(8) RESTRICTIONS PUTS INTO SERIOUS QUESTION THE VIABILITY OF THE BHCA AND THE NATIONAL BANK POLICY IT ESTABLISHES. INTERPRETING THE ACT TO PERMIT BHCs TO SELL INSURANCE THROUGH BANKING SUBSIDIARIES WHILE BARRING THE IDENTICAL ACTIVITY IF CONDUCTED THROUGH A NON-BANKING SUBSIDIARY WOULD CONSTITUTE EXACTLY THE SORT OF STERILE APPROACH REJECTED BY THE ELEVENTH CIRCUIT IN THE U.S. TRUST CASE. SUCH AN INTERPRETATION OF THE BHCA RIDICULES CONGRESSIONAL INTENT AND IS EQUIVALENT TO A NULLIFICATION OF THE ACT. NOWHERE IN THE LEGISLATIVE HISTORY OF THE BHCA DOES IT DELEGATE TO THE STATES OR TO THE

REGULATORS THE AUTHORITY TO UNRAVEL THE CAREFULLY CONSTRUCTED REGULATORY SYSTEM UNDER THE BHCA. ONLY CONGRESS IS INVESTED WITH THAT AUTHORITY AND, ACCORDINGLY, IT IS CONGRESS WHICH MUST UPHOLD THE INTENT AND PURPOSE OF THAT ACT.

IS THERE A SOLUTION TO THE ALLEGED "SOUTH DAKOTA" LOOPHOLE IN THE BHCA? WE BELIEVE THERE IS, MR. CHAIRMAN. THE DODD AMENDMENT FROM YOUR BILL OF LAST YEAR, S. 2851, APPROPRIATELY CLARIFIES THE BHCA'S TITLE VI RESTRICTIONS. THE DODD LANGUAGE, "IT IS NOT CLOSELY RELATED TO BANKING OR MANAGING OR CONTROLLING BANKS FOR A BANK HOLDING COMPANY OR ANY SUBSIDIARY OR AFFILIATE THEREOF TO PROVIDE INSURANCE AS A PRINCIPAL, AGENT, OR BROKER..." (S. 2851, P. 17, LINES 20-24) MAKES CLEAR WHAT HAS ALWAYS BEEN INTENDED BY THE TITLE; THAT IS, TITLE VI RESTRICTIONS APPLY TO ALL AFFILIATES AND SUBSIDIARIES OF THE BHC, NOT JUST ITS NON-BANKING SUBSIDIARIES. AS STATED LAST YEAR BY THE AUTHOR OF TITLE VI, THE HONORABLE GEORGE MITCHELL OF MAINE:

> IT [TITLE VI] WAS NEVER INTENDED TO MEAN ANYTHING ELSE. THE DODD AMENDMENT BREAKS NO NEW LEGISLATIVE GROUND, OVERTURNS NO PREVIOUSLY RECOGNIZED STATES' RIGHTS OR DUAL BANKING PRINCIPLES, REPRESENTS NO NEW LEGISLATIVE AGENDA. (CONGRESSIONAL RECORD, SEPT. 13, 1984, P. S. 11143)

AS YOU KNOW, MR. CHAIRMAN, THE DODD AMENDMENT WAS CHALLENGED ON THE SENATE FLOOR BY THE HONORABLE SLADE GORTON OF WASHINGTON. THE DODD AMENDMENT WAS UPHELD FIRST BY THE SENATE BY A VOTE OF 38 TO 56 AGAINST THE GORTON AMENDMENT AND AGAIN BY THE SENATE BY AN OVERWHELMING VOTE IN FAVOR OF YOUR BILL, S. 2851.

THE DODD LANGUAGE WAS ALSO INCLUDED IN THE HOUSE BILL, H.R. 5916, WHICH WAS REPORTED TO THE HOUSE OF REPRESENTATIVES BY THE HOUSE BANKING COMMITTEE LAST YEAR. WE BELIEVE, MR. CHAIRMAN, THAT THE DODD AMENDMENT HAS BEEN TESTED, AND THE RESULT IS AN OVERWHELMING MANDATE IN ITS FAVOR.

You yourself, Mr. Chairman, have challenged this solution on the basis of states' rights and have suggested too that the Dodd Amendment brings into question the insurance industry's federal antitrust exemption under the McCarran-Ferguson Act. Briefly, we would like to address both concerns.

Mr. Chairman, as Senator Mitchell stated so eloquently on the Senate floor in September of 1984, the intent of the BHCA is "to establish the outer boundaries within which bank holding companies and their subsidiaries may operate." (Congressional Record, Sept. 13, 1984, P. S. 11142). It was never intended for states through state-chartered bank affiliation with BHCs to preempt the BHCA through laws that were less restrictive than the federal statute.

If we look back again at the legislative history of the Act, we find that Congress and the Federal Reserve Board Chairman share this view. In March 1980, the Honorable Jerry Patterson of California explained in the House Report of the predecessor to Title VI, H.R. 2255, that Rep. George Hansen's amendment to H.R. 2255, which would

HAVE GIVEN LIBERAL PREEMPTIVE AUTHORITY TO THE STATES, WAS DEFEATED BECAUSE IT WOULD CREATE A DANGER: "...THE DANGER OF SECTION 2 [THE HANSEN LANGUAGE] IS THAT IT WOULD PERMIT LESS RESTRICTIVE STATE LAWS TO PREEMPT FEDERAL BANK HOLDING COMPANY LEGISLATION." (HOUSE REPORT No. 96-845, P. 13)

IN THAT SAME REPORT, THE CHAIRMAN OF THE FEDERAL RESERVE BOARD, PAUL VOLCKER, IS CREDITED WITH WRITING TO CHAIRMAN ST GERMAIN ON THIS VERY ISSUE:

> UNDER SECTION 7 OF THE BANK HOLDING COMPANY ACT, 12 U.S.C. 1846, THE AMOUNT AND KINDS OF INSURANCE THAT A BANK HOLDING COMPANY MAY PROVIDE MAY BE FURTHER RESTRICTED BUT NOT EXPANDED BY STATE LAW. (HOUSE REPORT No. 96-845, P. 15)

MR. CHAIRMAN, AGAIN WE WOULD LIKE TO EMPHASIZE THAT WE SHARE SENATOR MITCHELL'S VIEW THAT SECTION 7 OF THE BHCA IS INTENDED ONLY TO ALLOW STATES TO FURTHER RESTRICT BANK HOLDING COMPANY OPERATIONS WITHIN THEIR STATE BORDERS. "IT IS NOT INTENDED TO PERMIT THE ACT'S

SUMMARY REPEAL BY THE ACTIONS OF A SINGLE STATE." (CONGRESSIONAL RECORD, SEPT. 13, 1984, P. S. 11142). WE BELIEVE FURTHER, MR. CHAIRMAN, THAT LEGISLATIVE HISTORY EMBRACES THIS SAME VIEW.

ON ANOTHER POINT RELATED TO THE STATES' RIGHTS ISSUE, WE WANT TO MAKE IT ABSOLUTELY CLEAR THAT THE DODD LANGUAGE IN NO WAY TREADS UPON THE RIGHTS OF STATES TO DECIDE WHATEVER THEY BELIEVE IS APPROPRIATE FOR THEIR FREE-STANDING STATE-CHARTERED BANKS. THAT IS A STATE PREROGATIVE. HOWEVER, BHCS ARE CREATURES OF FEDERAL LAW AND ONCE ANY BANK BECOMES AFFILIATED WITH A BHC, CONGRESS INTENDED THAT THE BHCA WOULD ESTABLISH WHAT IS APPROPRIATE FOR BHCS, NOT THE STATES.

FINALLY, MR. CHAIRMAN, WE FIND IT NECESSARY TO ADDRESS THE ISSUE OF THE MCCARRAN-FERGUSON ACT. CONGRESS ENACTED THE MCCARRAN-FERGUSON ACT EXPRESSLY TO LEAVE TO THE STATES THE AUTHORITY TO REGULATE THE BUSINESS OF INSURANCE. SOME HAVE EXPRESSED CONCERN THAT CLOSING THE "SOUTH DAKOTA" LOOPHOLE REPRESENTS AN UNJUSTIFIED FEDERAL INCURSION UPON THE AUTHORITY OF THE STATES UNDER MCCARRAN-FERGUSON. SUCH CONCERNS ARE UNWARRANTED.

THE BHCA IS A FEDERAL BANKING STATUTE WHICH LIMITS THE ACTIVITIES IN WHICH BANK HOLDING COMPANIES MAY ENGAGE. BY ITS EXPRESS TERMS, THE BHCA FORBIDS BANK HOLDING COMPANIES FROM UNDERTAKING MOST FORMS OF INSURANCE OPERATIONS.

THE PURPOSE OF "SOUTH DAKOTA" LOOPHOLE CLOSING LANGUAGE IS TO CLARIFY EVEN FURTHER THAT THE INSURANCE LIMITATIONS OF CURRENT LAW APPLY TO BHCS AND ALL OF THEIR VARIOUS COMPONENTS, INCLUDING THEIR STATE-CHARTERED BANKS. THAT LANGUAGE SPEAKS TO THE AUTHORITY OF FEDERAL ENTITIES -- BHCS -- TO ENGAGE IN A PARTICULAR ACTIVITY - INSURANCE. IN NO WAY DOES THE LANGUAGE INTERFERE WITH THE HISTORICAL AUTHORITY OF THE STATES TO LICENSE AND REGULATE INSURANCE COMPANIES AND AGENTS OPERATING WITHIN THEIR BORDERS. AS A CONSEQUENCE, CLOSING THE "SOUTH DAKOTA" LOOPHOLE DOES NOT IN ANY RESPECT INTERFERE WITH OR DIMINISH THE TRADITIONAL AUTHORITY OF THE STATES TO REGULATE THE BUSINESS OF INSURANCE.

IT IS ALSO IMPORTANT TO REEMPHASIZE WITHIN THIS CONTEXT THAT BHCS ARE CREATURES OF FEDERAL LAW; HENCE, IT IS CONGRESS, NOT THE

STATES, WHICH HAS THE AUTHORITY TO DECIDE WHAT ACTIVITIES ARE APPROPRIATE FOR BHCs. THUS, CONGRESS AND THIS COMMITTEE IN PARTICULAR ARE THE CORRECT FORUM TO WHICH THE INSURANCE INDUSTRY MUST PRESENT ITS CASE.

IN CONCLUSION, MR. CHAIRMAN, LET ME SUMMARIZE THE HIGHLIGHTS OF OUR TESTIMONY.

- WE BELIEVE STRONGLY THAT CONGRESS DECIDED BACK IN 1956 THAT IT IS NOT THE MARKETPLACE, BANKS, LAWYERS OR THE STATES WHICH ESTABLISH NATIONAL BANK POLICY. IT IS ONLY THE CONGRESS WHICH HAS THAT BROAD POWER. AND INDEED, CONGRESS DEMONSTRATED ITS AUTHORITY IN 1956 THROUGH THE ENACTMENT OF THE BHCA. CONGRESS CONTINUES TO GOVERN NATIONAL BANK POLICY THROUGH ITS OVERSIGHT AUTHORITY OVER THAT ACT AND ITS FEDERAL REGULATOR.
- FOR THAT VERY REASON, WE BELIEVE IT IS CONGRESS THAT MUST DECIDE WHAT IS IN THE PUBLIC INTEREST IN THIS AREA. IT IS CONGRESS' RESPONSIBILITY TO PROVIDE FOR, THROUGH

THE BHCA, A SAFE, SOUND AND COMPETITIVELY FAIR BANKING SYSTEM.

- TO FULFILL THIS MANDATE, CONGRESS MUST CLOSE THE ALLEGED "SOUTH DAKOTA" STATE-CHARTERED BANK LOOPHOLE IN THE BHCA ON BOTH AN INTRA- AND INTERSTATE BASIS. THE ISSUE IS NEITHER STATES' RIGHTS NOR THE EXPANSION OF THE TITLE VI INSURANCE RESTRICTIONS. CONGRESS RESTRICTED THE INSURANCE ACTIVITIES OF BHCs BACK IN 1982; THE DODD AMENDMENT MERELY CLARIFIES THE ORIGINAL INTENT OF THE PROVISION. HOWEVER, THE ISSUE IS WHETHER CONGRESS CHOOSES TO CLARIFY AND STRENGTHEN THE ORIGINAL INTENT AND PURPOSE OF THE BHCA AND ALL OF ITS COMPONENT PARTS.

- WE PROPOSE THAT THE DODD AMENDMENT FROM LAST YEAR'S BILL, S. 2851, OR LANGUAGE SIMILAR TO IT, SUCH AS THE "SOUTH DAKOTA" LOOPHOLE CLOSER LANGUAGE CONTAINED IN SENATOR MATTINGLY'S BILL, S. 716, BE INCORPORATED IN ANY BILL CONSIDERED BY THIS COMMITTEE. THIS CLARIFYING AMENDMENT IS

NEEDED BOTH TO ENSURE THAT NATIONAL BANK POLICY IS NOT NULLIFIED BY STATE ACTION AND NO LESS IMPORTANT, TO ASSURE THAT NATIONAL BANK POLICY IS NOT CREATED BY LOOPHOLE LAWYERS. WE BELIEVE STRONGLY THAT IT IS IN THE BEST INTEREST OF THIS DELIBERATIVE BODY AND THE PUBLIC AS A WHOLE FOR THE CONGRESSIONAL INTENT OF THE BHCA, ITS TITLE VI PROVISIONS IN PARTICULAR, TO BE UPHELD AND ENFORCED ON BOTH AN INTRA- AND INTERSTATE BASIS.

THANK YOU, MR. CHAIRMAN, FOR THIS OPPORTUNITY TO APPEAR BEFORE YOUR COMMITTEE. MY COLLEAGUES AND I WOULD BE HAPPY TO ENTERTAIN ANY QUESTIONS YOU OR THE OTHER MEMBERS OF YOUR COMMITTEE MIGHT HAVE.

NALU The National Association of Life Underwriters
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STATEMENT OF

THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

ON

CHANGES IN THE FINANCIAL SERVICES INDUSTRY

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

U. S. SENATE

JUNE 19, 1985

Mr. Chairman, I am Kirk R. Englehardt, a life insurance agent from Salt Lake City, Utah. I am appearing before you this morning on behalf of the National Association of Life Underwriters (NALU) as a member of its Federal Law and Legislation Financial Institutions Subcommittee.

The National Association of Life Underwriters is a federation of approximately 1,000 state and local associations. These state and local associations have a combined membership of over 130,000 individual life and health insurance agents doing business in virtually every community in the United States.

Mr. Chairman, NALU completely supports the views expressed this morning by William T. Huntley, III of the National Association of Casualty and Surety Agents.

Mr. Huntley has set forth in comprehensive fashion the collective position of the insurance producers with respect to the need for legislation to close the "South Dakota" state-chartered bank loophole in the Bank Holding Company Act.

Mr. Chairman, almost one year ago, this Committee approved the Dodd Amendment to close the state-chartered bank loophole. Subsequently, the Dodd language withstood the challenge of Senator Slade Gorton on the Senate floor. It is lamentable that the 98th Congress failed to close this loophole.

Mr. Huntley cites in his testimony that one of the chief goals of the Bank Holding Company Act was to maintain the separa-

tion between banking and commerce. In 1982, Congress enacted Title VI of Pub.Law 97-320 (Garn-St Germain) which reaffirmed that policy, specifically with reference to insurance. Congress' decision was predicated upon protection of the consumer against unlawful credit tie-ins, conflicts of interest and concentration of economic power.

In the current clamor for expanded bank insurance powers, bankers maintain that by offering such services they will enhance competition and serve the best interests of the consumer. Let us examine that contention more closely in the context of the banks' record on credit life insurance and bank service fees which are important issues in themselves. However, they also serve as a useful lens through which one can focus on how the consumer might fare were banks to be accorded expanded insurance authority.

This Committee is well acquainted with the numerous congressional and regulatory studies conducted over the past several decades exposing the dangers of credit tie-ins relating to the sale of credit insurance in connection with small loans.

In his testimony before this Committee on March 6, 1984, David P. Woods, CLU included for the record a submission to the Federal Reserve Board (submission) by the insurance producer trade associations represented here today regarding the banks' record on credit-related insurance. That submission comprehensively set forth the banks' record of overcharging on credit-related insurance and coercing borrowers to purchase credit insurance. The producers' submission concludes that

> rapacious overcharging, failure to return unearned premiums when loans are paid off or the borrower dies during the term of the loan, failure to notify survivors of borrowers that loans have been paid off by credit insurance, and tying sales of credit insurance to extensions of credit have all been common practices in connection with credit insurance sales.

Tennessee Insurance Commissioner John C. Neff, who also serves as the Chairman of the NAIC's Credit Insurance Task Force, made the following observation in his comments filed January 9, 1984 to the Federal Reserve Board:

> ...the business of credit insurance in the United States is a national scandal. I know of no other product where the public is so blatantly abused by what are supposed to be responsible financial institutions...Every insurance commissioner in the United States has struggled valiantly to try to lower the price of this insurance to a fair level in the face of tremendous opposition by banks and other creditors...If there is a single reason why the various insurance commissioners are opposed to the banking industry entering the business of the sale and underwriting of insurance, it is credit life insurance. Every bank that I know of sells credit insurance at the maximum price allowed by law and makes no attempt to sell it at a price that would produce a fair return of benefits to consumers.

Commissioner Neff further indicated that on the basis of preliminary data gathered in a national basis for 1982 that "consumers are being overcharged by approximately $650,000,000," and he noted that this figure was a substantial understatement.

Credit life overcharges and tie-ins were amply demonstrated by the evidence adduced in the case of Independent Insurance

Agents of America (IIAA) v. Board of Governors of the Federal Reserve Board 736 F.2d 468 (1984). The Eighth Circuit Court of Appeals granted the application of Missouri's two largest bank holding companies, Commerce Bancshares, Inc. and Mercantile Bancorporation, to engage in the sale of credit-related property and casualty insurance but noted in the majority opinion that

> IIAA provided convincing evidence which showed that...both Commerce and Mercantile may have tied credit to the purchase of credit life insurance in the past. Evidence of high penetration rates in the credit life field was presented on both banks, as well as evidence that Commerce rewarded employees who sold substantial amounts of credit life with recognition and awards. Id at 474.

According to IIAA's appellate brief, Missouri's two largest bank holding companies acting as agents and as underwriters (through credit life reinsurance subsidiaries) had engaged in systematic campaigns to sell the highest possible volume of credit life and credit disability insurance at the highest commission level permitted by Missouri law (40 percent) and at rates 40 percent higher than identical coverages offered in Missouri by Prudential Insurance Company.

Despite the availability of the credit life insurance at more favorable rates elsewhere the evidence disclosed that Mercantile had 16 banking subsidiaries with credit life penetration rates of more than 60 percent. Ten of those subsidiaries had penetration rates in excess of 80 percent. One subsidiary had achieved a 98.8 percent penetration rate.

The market penetration rates of Commerce were even more impressive. Of Commerce's 38 banking subsidiaries, 14 had penetration rates in January 1981 of 80 percent or better. Four of Commerce's subsidiary banks achieved a 100 percent penetration rate.

On the basis of this evidence the Administrative Law Judge in this case concluded that both bank holding companies had been guilty of tying sales of credit insurance to extensions of credit.

In his dissenting opinion, Eighth Circuit Judge Ross took issue with the majority opinion to permit credit property and casualty insurance authority in the face of such evidence. He criticized the majority for failing to recognize the evidence and sworn testimony regarding the record of credit tie-ins. he stated,

> the majority recognized that both have enjoyed an unusually high success rate (penetration) in the sale of credit life insurance borrowers. We are confronted then with the specter of an extremely successful 'sales program' peddling overpriced coverage to a captive market...Enforcement of the law against coercive tying will be very difficult

As recently as February 26, 1985 the lead article on the front page of the Wall Street Journal (see Appendix A) set forth in considerable detail the dangers implicit when extenders of credit (banks, auto dealers, and consumer loan companies) can also sell insurance. The article reports of numerous cases of

consumers victimized by a credit tie-in arrangement known as "packing" in which

> a lender adds payment for optional insurance and other products to the amount of the loan without the customers' requesting them...Indeed many customers often don't want, need or even understand the products they have purchased. Victims are frequently poor, unsophisticated or so desperate for money that they will sign practically anything placed in front of them...

The bankers' purported concern for the consumer, however well intentioned, is further undermined by their own abysmal record on service fees. House Banking Committee Chairman Fernand St Germain was quoted as follows in the September 23, 1984 edition of the Washington Post:

> The fees have become a virtual buzz saw. Fees for deposits, fees for low balance savings accounts, with the 'low balance' arbitrarily defined by the bank, fees for transfer of funds, fees for closing accounts. In some cases the fees virtually wipe out the interest on small accounts, negating congressional efforts to give small savers a break.

Last week this Committee heard the testimony of Stephen Brobeck of the Consumer Federation of America who presented evidence concerning the dimunition in banking services available to the poor due to primarily "the tremendous escalation in bank fees and minimum balance requirements over the past several years; - secondarily, bank branch closings and reduced availability of services."

In conclusion, Mr. Chairman, I would urge the distinguished members of this Committee to look beyond the rhetoric of bank deregulation proponents who promise benefits to the consumer in view of the banks' own record which belies their claims.

THE WALL STREET JOURNAL TUESDAY, FEBRUARY 26, 1985

APPENDIX A

Unwanted Extras

Irate Borrowers Accuse ITT's Loan Companies Of Deceptive Practices

They Say Salesmen Burdened Them With Insurance That They Didn't Need

Reliance on Human Nature

By WALT BOGDANICH
Staff Reporter of THE WALL STREET JOURNAL

It was a month before Christmas 1983, and Katherine Snow, an unmarried mother, needed money. Subsisting on a monthly income of only $423, Ms. Snow sought help from Thorp Finance Corp., Wisconsin's biggest consumer-loan company.

Thorp, a unit of ITT Corp., the New York-based conglomerate, agreed to lend Ms. Snow $126.72. But it also induced Ms. Snow to borrow $14.74 for credit life insurance, $73.44 for property insurance and $202 for term life insurance. Finally, for an additional $34.56, Ms. Snow became a member of the ITT Consumer Thrift Club, entitling her to discounts on consumer products.

Ms. Snow would later say she didn't know she had purchased all the extras, financed at interest rates above 21%. "I bought more insurance than I borrowed money, if that makes any sense," Ms. Snow testified last year in circuit court in Dane County, Wis. In connection with a lawsuit filed by the Wisconsin attorney general charging Thorp with "deceptive and unconscionable" sales practices.

Wisconsin officials say Ms. Snow was a victim of "packing," a lucrative practice in which a lender adds payments for "optional" insurance and other products to the amount of the loan without the customer's requesting them.

Indeed, many customers often don't want, need or even understand the products they have purchased. Victims are frequently poor, unsophisticated or so desperate for money that they will sign practically anything placed in front of them, law-enforcement officials say.

Policy Violations

Packing has been a common practice in many parts of ITT's 37-state consumer-loan operation, according to former ITT employees and customers. ITT says its policies forbid the practice. The company declines to discuss individual cases, but John S. Thomas, general counsel for ITT Consumer Financial Corp., which manages ITT's consumer-loan business, says: "Our company policy is crystal clear: Each customer is to understand the products they purchased and that the purchase of them is voluntary." Internal company memorandums, however, show that branch managers were ordered to sell certain amounts of insurance in connection with loans, or face disciplinary action.

Some former employees say they couldn't meet company goals without packing insurance that customers didn't want into loan agreements. Packing violates federal and many states' laws if lenders coerce borrowers into buying insurance from them as a condition for getting loans or if that insurance isn't fully explained.

ITT is by from being the only concern accused of overzealously selling insurance with consumer loans. Banks, auto dealers and other consumer-loan companies are involved, too, and regulators say the problem has gotten worse. "The problem of credit life insurance in the U.S. is a national scandal," says John C. Neff, Tennessee's commissioner of commerce and insurance. "I know of no other product where the public is so blatantly abused by what are supposed to be responsible financial institutions."

With banks moving more into the insurance business, the potential for tying the extension of credit to the purchase of insurance increases, some state regulators worry.

'Convincing Evidence'

Last June, a federal appeals court in St. Louis affirmed the right of two Missouri bank holding companies to sell credit-related insurance, but the court expressed concern about the high volume of insurance sold by both banks. The court said "convincing evidence" had been presented showing that Commerce Bancshares Inc. and Mercantile Bancorporation Inc. "may have tied credit to the purchase of credit life insurance in the past."

Lenders sell optional insurance because it is profitable. ITT, for example, charges interest not only on its consumer loans but also on money borrowed to pay for insurance included in the loan package. The company then sells credit life insurance to cover the entire amount borrowed. Mr. Neff points out that credit-life-insurance companies pay out less in claims than homeowner and auto insurers.

Several states have recently lowered the maximum allowable charge for credit-related insurance, but some state regulators complain that the combined lobbying power of the banks, consumer-loan companies and car dealers continues to keep rates high.

The potential for packing profitable insurance into consumer-loan transactions has increased as lenders have added more "optional" insurance products to their sales line.

ITT Financial Corp., ITT's consumer-loan subsidiary, now sells five types of insurance policies and also offers membership in the ITT Consumer Thrift Club, which sells discounted consumer products.

David J. Gilles, assistant attorney general of Wisconsin, says he hasn't seen any company match ITT's proficiency at selling these multiple insurance products onto consumer-loan transactions. Some states have either taken or threatened legal action against ITT.

Last October, the Wisconsin attorney general reached an out-of-court settlement with ITT that could return as much as $12 million to 12,000 Wisconsin policyholders, state officials say. ITT in May reached a similar settlement for almost $560,000 with the Iowa attorney general.

ITT is also negotiating a possible settlement with Minnesota authorities, and the company's lending practices are under investigation in Colorado. Class-action suits alleging insurance packing are pending against ITT in Wisconsin, Alabama and Arizona.

ITT's consumer-loan business operates under the names of Thorp, Aetna Finance Co. (no relation to Aetna Life & Casualty Co.) or ITT Financial Services, depending on the location. The company also has offices in Puerto Rico and some Caribbean islands.

Mr. Thomas, ITT Consumer Financial Corp.'s general counsel, says ITT settled with Wisconsin and Iowa "in order to get back to the business of serving the financial needs of our customers." As for other investigations, Mr. Thomas says, "I'm confident that we'll be able to resolve any matters . . . to the satisfaction of various states."

Before reaching its settlement with ITT, Wisconsin authorities produced a parade of witnesses who told how they were fooled or pressured into buying unwanted insurance.

Deborah Woltalewicz of Stevens Point, Wis., testified she stopped at a Thorp office for a $100 loan to replace worn tires on her car and wound up buying three insurance policies costing another $200. Patrick C. Dorn, a college student living with his parents, said he borrowed money from Thorp to buy a used car and ended up buying accidental-death, term life, property and credit disability insurance. Both borrowers said they didn't fully understand what they were buying.

"It's the implied consent method of closing a loan," says Stephen J. Hicks, the head of the consumer-protection division in the Wisconsin attorney general's office. "Until somebody says, 'I don't want the insurance,' you pack it in and don't explain it."

Anthony Figueroa, a 25-year-old former branch manager of Aetna Finance in suburban Phoenix, Ariz., says he never mentioned insurance until he informed customers by telephone that their loans had

loan approved. "You never really went into it in detail," Mr. Figuroa explains. "Over the phone, I'll say your payments are $132 for 36 months . . . with our full insurance package."

He says it was important to hurry a customer through the final closing of the loan. "Basically, you want (customers) in and out, period. And you are putting sheet after sheet in front of them, and they aren't reading any of it."

Mark Lilly, a 26-year-old former branch manager in Tucson, says customers were often unaware they bought insurance. "Usually nature is that you are happy to death the loan is approved, so when the payment amount was disclosed, it was fine," Mr. Lilly says.

Both Messrs. Figuroa and Lilly say they voluntarily left the company because of management pressure to sell the insurance. "It got to the point where I didn't like myself personally for what I was doing," Mr. Figuroa says.

Monique Hawkins says she was a victim of this selling procedure. Young, financially unsophisticated and in need of money in a hurry, Miss Hawkins had only recently moved to St. Paul, Minn., from her parents' home in Wisconsin when she overextended herself on credit-card purchases.

"I was only 18, and I was trying hard to be real independent," says Miss Hawkins. "I didn't want to call my parents." Instead, she called Thorp.

In 1984, Miss Hawkins asked to borrow $1,500. Thorp declined, but said it could lend her $700 to $800. Miss Hawkins says she agreed, and when she arrived at Thorp's office in St. Paul, she found that most of the loan documents had already been prepared, including insurance that hadn't been previously discussed.

"I didn't like the idea that they just assumed you wanted all this," she says. But under pressure from her loan officer, Miss Hawkins says, she bought credit disability, credit life and term life insurance without fully realizing what it all was. The optional insurance cost her an extra $275 with Thorp providing the financing. Her total debt, including the purchase of an ITT Thrift Club membership: $1,523.

State investigators in Iowa found borrowers with similar complaints, as well as instances where Thorp customers bought property insurance on property that already was insured. "They were being required to insure the same property twice," says Richard L. Cleland, the head of the consumer-protection division of the Iowa attorney general's office. Customers also bought household-contents insurance for an amount that far exceeded the value of their household goods, Mr. Cleland says.

The cost of optional insurance sometimes totaled in the thousands of dollars. Charles R. Pyle, a Tucson lawyer, says he settled a lawsuit in 1984 with Aetna Finance after charging that the company packed insurance premiums of about $6,200 on top of his clients' $10,000 loan. As part of the settlement, Mr. Pyle agreed to abide by Aetna's request not to divulge the amount of the settlement.

Mr. Pyle said Aetna Finance was aware, for example, that his clients, Antonio and Maria Urbina, already had household-goods insurance, yet sold it to them anyhow. "Our allegation was that Aetna encourages them (loan officers) to sell as much of this as possible, regardless of what benefit it has to the client," Mr. Pyle says.

According to former employees of ITT's loan offices, the offices were expected to sell insurance with certain percentages of the loans they made. These percentages were sometimes called penetration rates. "It was everyday pressure that started when you walked in the door," says Mr. Figuroa, one of the former Phoenix branch managers. He says penetration rates were tracked daily.

David Laws, a former branch manager for Aetna Finance in Greenville, Miss., says that in 1983 he was expected to have penetration rates of 95% on credit life, 90% on credit disability, 85% on household contents, and 35% for accidental death and term life combined.

Mr. Laws, whose former office is in the economically depressed Mississippi Delta, says his clients couldn't afford to pay for the extra insurance. When he consistently failed to meet his penetration goals, Mr. Laws says, he was fired Sept. 6, 1983. In a federal lawsuit alleging wrongful termination filed by Mr. Laws in U.S. District Court in Greenville, Miss., Mr. Laws contends that "insurance penetration standards or goals" couldn't be reached without violating state and federal law.

Mr. Thomas, the general counsel for ITT Consumer Financial Corp., says Mr. Laws's firing had nothing to do with the sale of insurance. Mr. Thomas added: "We have goals; we don't have standards, requirements or quotas."

But ITT's internal memorandums tell a different story. A 1982 memo from ITT Consumer Financial Corp.'s Atlanta office, one of the company's five regional headquarters, addresses one branch manager's failure to meet the company's expected penetration rate for an accidental-death policy called Unipay.

"As you well know," the memo says, "the company standard is 30%. . . . I am sure you are well aware of the requirements regarding this product line and I want you to know that I hold you accountable and responsible for achieving this requirement."

On May 26, 1983, Brian P. Brouillard, a divisional director in Atlanta overseeing 13 offices in three states, sent the following notice to branch managers in Mississippi: "Joint Life Penetration must improve. . . . When a loan is a joint signature loan, write joint insurance." The memo concludes, "You will achieve the acceptable ratio of 50% in the future."

In another 1983 memo, Mr. Brouillard said he would delay a branch manager's salary review if the manager failed to meet the company's Unipay penetration standard. Mr. Brouillard stated his reasons for exerting this pressure in another memo: "Our income is predicated on insurance income. Quite [sic] simply, the more net premium sold, the more profit."

Mr. Brouillard declines comment. Mr. Thomas, the general counsel, says these memos violated company policy. "That's not the way the company desires to do business," he emphasizes.

Mr. Thomas says that because of recent lawsuits against ITT, "we have taken what I believe are some quite extraordinary steps in reemphasizing the supervision of our field offices." In addition, ITT now follows up loan transactions with a letter in which customers are reminded of insurance they purchased and told that if they have questions, they can call a toll-free customer-service number.

But Mr. Hicks, the consumer-protection chief in the Wisconsin attorney general's office, points out that previous attempts by ITT to deal with the problem of insurance packing have failed. State records show that regulators in Wisconsin had been complaining to ITT about insurance packing since 1979.

And Mr. Hicks notes that ITT didn't agree to a settlement in Wisconsin until the attorney general last September asked a Wisconsin judge to cite ITT for contempt of court, after state investigators found widespread violations of an earlier court order prohibiting insurance packing. (Mr. Thomas says ITT fired six employees last year for violating that order.)

Lynde K. Johnson of Somerset, Wis., is one person who thinks ITT still has room for improvement. On Jan. 3, he borrowed $534 from a Thorp office in St. Paul, Minn., to pay for a stereo. Mr. Johnson says he thought he only purchased insurance that would pay off the loan if he died or was disabled.

But after leaving the office, Mr. Johnson says, he discovered that he also borrowed money to buy property insurance and a single-premium term-life-insurance policy. In anger, Mr. Johnson says he called a Thorp official to complain: "I told him I don't need two life-insurance policies."

And the official's response? "He said well, it's nice to have an extra one," Mr. Johnson says he later canceled the policy.

Statement by

David L. Ream, CIC,CPIA
Chairman
Government Affairs Committee

of the National Association of

PROFESSIONAL INSURANCE AGENTS

concerning

CHANGES IN THE FINANCIAL SERVICES INDUSTRY

Submitted to the

Committee on Banking, Housing,

and Urban Affairs

of the

United States Senate

June 19, 1985

Mr. Chairman and distinguished Members of the Committee on Banking, Housing, and Urban Affairs, I am David L. Ream, CIC, CPIA, a Vice-President of the National Association of Professional Insurance Agents (PIA) and Chairman of PIA's Government Affairs Committee. I am an independent insurance agent from Cleveland, Ohio.

PIA is a national trade association representing more than 40,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico and the U.S. Virgin Islands.

PIA has followed with considerable interest the changes taking place in the financial services industry over the last 15 years. This is especially true regarding the continuing efforts of bank holding companies (BHCs) and other depository institutions to become involved in the business of insurance.

I welcome this opportunity to appear before this Committee today on the insurance producers witness panel. PIA's members have voiced their opposition to banking and thrift entities underwriting and selling insurance before Congressional Committees, state legislatures and regulatory bodies whenever a forum becomes available.

I would like to begin by stressing to the Committee our position that keeping the banks out of the business of insurance is a matter of the very highest priority to PIA's membership. Our position is well established. We oppose depository institutions participating in any aspect of the insurance business.

Over the years, the realities of the political process have required us to accept some compromises. However, what has not changed is our fundamental belief that depository institutions and insurance should not mix as a matter of sound public policy.

PIA unequivocably supports and endorses the statement submitted for the hearing record today by the Insurance Producer Coalition's spokesman, William T. Huntley, III, CPCU. This statement expresses the views of all members of this coalition.

The banks-in-insurance issue under consideration by the Committee today is not new, Mr. Chairman. We are all very familiar with it. Extensive hearings were held on this subject in the 97th, 98th and 99th Congresses. This issue was a point of some contention during the consideration of Title VI of the Garn-St Germain Depository Institutions Act which became law in 1982, and the Dodd Amendment, that was part of S.2851, the Financial Services Competitive Equity Act, which passed the Senate last September by a vote of 89 yeas to 5 nays. The philosophical and legal arguments on all sides of this controversy have been presented, frequently debated and considered in minute detail by Committee Members, staffs and lobbyists, espoused by grass roots participants, and pondered by Members of Congress.

The financial services issues that are the subject of this series of hearings will remain a matter of serious controversy as long as the Congress continues to postpone taking the required legislative steps needed to put the nations financial services house back in order and provide the necessary statutory guidance to restore regulatory stability and predictability. The evolution

of this process can no longer be left to the loophole lawyers, alleged loophole exploiters and non-regulating regulators. Congress must exercise its prerogatives and come to grips with this situation. The longer it delays, the more politically difficult a workable solution becomes.

The need for legislative action is amply illustrated by what has become known as the so-called state law/South Dakota loophole. In 1982, Congress enacted and the President signed into law the Garn-St Germain Depository Institutions Act (Garn-St Germain). Title VI of Garn-St Germain prohibited insurance activity by BHCs, with limited exceptions, and established that insurance was not closely related to banking in Section 4(c)(8) of the Bank Holding Company Act. This placed a major new legal barrier in the path of the determined insurance ambitions of certain major money center BHCs.

So committed was Citicorp to getting into the insurance business, Title VI notwithstanding, that they began to search for a way around the Title VI insurance restrictions. As we all know, their innovative lawyers and lobbyists went out to South Dakota and convinced that state that they had discovered a "loophole" to Title VI that would bring new jobs and tax revenues into that state. All South Dakota had to do was amend their state banking laws.

The South Dakota loophole was promoted to that state on the proposition that Section 4(c)(8) only limits the activities of non-banking subsidiaries of BHCs and that banking subsidiaries that are state state-chartered banks are controlled by state law. If a state authorizes a non-banking activity for its state-

chartered banks, BHCs owning such banks can participate in said activity even though it is prohibited to BHCs by the BHC Act. An interesting promotion theory indeed!

There is a serious problem with Citicorp's theory because the existance of a South Dakota loophole is not supported by the legislative history of Title VI. The House Conference Report that explains Title VI states that,

> "The Senate Amendment generally prohibits bank holding companies and their subsidiaries from providing insurance, including property and casualty insurance products, as a principal, agent, or broker, with six specific exceptions enumerated in the Title." (emphasis here added) (House Report No. 97-899, P. 91)

The linchpin, for our purposes, in the aforementioned quotation from the Conference Report is " ... and their subsidiaries ...". The word "subsidiaries" is not qualified or limited in any manner whatsoever. It must therefore logically mean what it says, "subsidiaries" and bring all subsidiaries of a BHC, banking and non-banking alike, within the scope of Section 4(c)(8) of the BHC Act, as amended by Title VI.

As will be cited later in this statement (see the remarks of Senator Mitchell on P, 6, 7) and in the joint statement submitted by the Insurance Producer Coalition, there are ample additional expressions of Congressional intent to leave no doubts that the insurance prohibitions of Title VI covers BHCs and all of their subsidiaries, no matter how they happen to be structured as a holding company.

When Citicorp, First Interstate Bancorp, and BankAmerica Corporation filed applications in 1983 to each acquire a South

Dakota-chartered bank to take advantage of South Dakota's law authorizing out-of-state BHCs to acquire state banks authorized to engage in insurance nationwide, the Federal Reserve Board (Fed) concurred with the position expressed in the aforementioned House Conference Report.

> "Taking account of the important and fundamental legal and policy issues raised by these applications, and their pending consideration before the Congress, the Board reached the tentative judgment that it could not approve the proposed bank acquisitions in view of present law and expressions of Congressional intent. ...". (emphasis here added) Federal Reserve Press Release, Jan. 6, 1984.

These BHCs asked the Fed to suspend the processing of their applications. Last winter, Citicorp and BankAmerica Corporation reactivated their suspended applications. On June 10, 1985, BankAmerica Corporation withdrew its reactivated application. A Fed ruling on Citicorp's reactivated application may soon be forthcoming.

Those advocating the use of state law and state-chartered bank subsidiaries as a way for BHCs to get around the insurance restrictions of Title VI have fueled considerable debate and public controversy. That controversy came to rest in the Senate Banking Committee where it gave birth to the amendment to S.2851 that has become known as the Dodd Amendment. Section 4(c)(8) of the BHC Act currently reads that, "it is not closely related to banking for a bank holding company to provide insurance...". The Dodd Amendment would change this to read, "It is not closely related to banking for a bank holding company or any subsidiary

or affiliate thereof to provide insurance ...". (emphasis here added). The purpose of this additional language, "... or any subsidiary or affiliate thereof ...". is to further clarify the scope of Title VI for those who needed such clarification, and inform Citicorp and their loophole allies, that Title VI reaches to all components of a BHC system.

The need for the Dodd Amendment was clearly put into focus by Senator George J. Mitchell (D-ME), the original author of the legislation that became Title VI, in his Floor remarks during the debate on the Gorton Amendment last September:

> "At no time during the drafting, explanation, or discussion of my legislation was there any suggestion that the language now contained in Title VI was intended not to apply to the subsidiaries of bank holding companies. It was and is intended to apply to bank holding companies and their subsidiaries.
>
> ... the Bank Holding Company Act has consistently been interpreted to establish the outer boundaries within which bank holding companies and their subsidiaries may operate. It is clear from the language of the act itself that the authority delegated to the States under section 7 is designed to prohibit or further restrict bank holding company operations within a State's borders. It is not intended to permit the act's summary repeal by the actions of a single State.
>
> ... the committee report's legislative history for both the 1982 Garn/St Germain Act and the Dodd Amendment adopted in the Senate Banking Committee this summer, the application of title VI insurance restrictions to the entire bank holding company system--not just to the parent holding company--is made explicit. ... The House Banking Committee report to H.R.5916, which contains language identical to the Dodd amendment, notes that the language is intended to "clarify and emphasize congressional intent that title VI extends to bank hold-

> ing companies and their subsidiaries, including bank subsidiaries, be they federally or State chartered." Finally in the Senate Banking Committee's report on the Dodd amendment, the amendment's purpose is to "specifically emphasize that all subsidiaries and affiliates of a bank holding company, including State bank subsidiaries and their affiliates, are subject to the insurance activities prohibitions and restrictions of title VI of the Garn/St Germain Act."
>
> The important point to emphasize in light of this review of legislative history and agency interpretation is that title VI has always applied to the subsidiaries and affiliates of bank holding companies. It was never intended to mean anything else. The Dodd amendment breaks no new legislative ground, overturns no previously recognized States rights or dual banking principles, represents no new legislative agenda. (emphasis here added)
>
> The Dodd language does not affect in any respect the insurance activities which may be authorized by applicable State laws for State chartered banks not affiliated with holding companies. Only State banks which choose either to organize themselves into bank holding companies, or be acquired by a holding company, are and have since 1982 been subject to the bank holding company act restrictions contained in title VI.
>
> The Dodd language is a necessary response to a deliberate strategy by some bank holding companies to circumvent restrictions on their activities which Congress enacted in 1982." Congressional Record, Sept. 13, 1984, PP S.11142-11143

PIA concurs with Senator Mitchell's analysis of the issues hereinvolved.

When the Gorton Amendment to weaken the Dodd Amendment came up for a vote after extensive debate, it failed by a vote of 38 yeas to 59 nays. Congressional Record, Sept. 13, 1984, P. S11150.

PIA believes that it is reasonable to conclude that a clear majority of the Senate supported the Dodd Amendment, as reported in S.2851.

Identical language to the Dodd provision was also a provision of H.R.5916, the Financial Institutions Equity Act of 1984, reported by the House Banking Committee. Unfortunately, the House failed to complete action on this bill prior to adjournment sine die. Consequently, the issues covered by S.2851 and H.R.5916 still remain unresolved.

PIA's support for Title VI and the Dodd Amendment continues to be based on our belief in the concept of fair competition in the insurance marketplace. Fair competition benefits consumers and insurance producers. We strongly believe that if BHCs obtain the authority, directly or indirectly, to engage in the general business of insurance, it will be to the detriment of the insurance consuming public.

The American economy is a credit economy. Obtaining necessary credit frequently takes the form of loans from depository institutions. When a consumer or business person goes to their banking entity for a loan, it is rare that the relationship involves negotiations between parties of equal bargaining power. Borrowers visit their banker, hat in hand, to obtain credit that may be vital to their personal or business situation. The first question usually asked a potential borrower by the lending officer is, "Do you have an account with this institution?" This sets the tone for the loan qualification process and the relationship that follows. If all goes well, the final element needed to secure the loan is

an assurance that the lender's interest will be protected for the amount and duration of the loan. For the vast majority of consumer and small business loans, the most available instrument to the borrower and most desirable to the lender is an insurance policy.

This fundamental relationship between credit and insurance raises serious public policy questions concerning the advisability of allowing depository institutions into the insurance business. Such a relationship is ripe with opportunities to induce borrowers to purchase the lender's insurance products. The connection need not be explicit. It is implied in the very nature of the transaction. It, indeed, becomes the epitome of the power of suggestion. Consumers and business borrowers are anxious to obtain or protect a line of credit and it doesn't take long for them to conclude that by purchasing their insurance needs from the lending institution their prospects for obtaining credit may well be improved.

Consequently, a decision will probably be made to buy insurance from the lender even though the purchaser may be well aware that the same, or better, coverage can be obtained at a lower price backed by better service in the highly competitive insurance marketplace. Obtaining or protecting that line of credit becomes the all important thing which, as a practical matter, has lessened the consumers freedom of choice in making insurance purchases.

This relationship also places the independent insurance agent at a very unfair competitive disadvantage. Our products and counseling are purchased on the strength of the protection, competitive price and quality of service rendered. The power of

the credit/insurance tie-in of the lender cannot be matched by the insurance agent and his products. We would be precluded from competing for the insurance business of such borrowers.

This may be what the banking industry calls "the level playing field" in insurance but it does not appear very level to us. In reality, it would be slanted to favor depository institutions because of the inherent competitive advantage that they have because of their protective federal safety net and the ability to leverage credit to sell insurance and other non-banking financial services. This is why the BHC Act limits the non-banking commercial activities of BHCs to preserve a competitive environment.

PIA urges the Committee to move resolutely forward with its financial services legislative agenda. The Dodd Amendment, as reported in S.2851 last year, or similar state law/South Dakota loophole closer language such as Section 103(d) of S.716, introduced by Senator Mack Mattingly (R-GA) on March 20, 1985, should be <u>included</u> in <u>any</u> financial services measure considered by this Committee. The South Dakota loophole must be put to rest for good so that loophole lawyers and their supporters do not continue to attempt to bypass the insurance restrictions of Section 4(c)(8) of the BHC Act.

PIA also urges that the Committee bill should close the so-called non-bank bank (NBB) loophole. Within this context, we must note that closing the NBB loophole will preclude non-banking entities, such as insurance companies, from acquiring banks contrary to the policy of the BHC Act. It is therefore only fair

that if insurers are to be kept out of banking, the Dodd Amendment should also be enacted to keep banking institutions out of insurance.

Thank you again for this opportunity. I would be happy to respond to any questions from the Committee Members.

* * * *

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July 24, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing,
and Urban Affairs
U.S. Senate
Room 534
Dirken Senate Office Building
Washington, D.C. 20510

Dear Senator Garn:

We have been asked by William T. Huntley of the National Association of Casualty and Surety Agents to provide your Committee with three sets of responses to the questions you and Senator Riegle enclosed with your July 1, 1985 letter to Mr. Huntley.

Should you have any questions about the enclosure, please let us know.

With best regards,

Sincerely,

CHARLES, KARALEKAS, McCAHILL & WILSON

Thomas E. Wilson
Counsel for the National Association
of Casualty and Surety Agents

TEW/bam
Enclosures

July 24, 1985

RESPONSES OF THE
INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.,
THE NATIONAL ASSOCIATION OF CASUALTY AND SURETY AGENTS,
THE NATIONAL ASSOCIATION OF INSURANCE BROKERS,
THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS,
THE NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS,
AND
THE NATIONAL ASSOCIATION OF SURETY BOND PRODUCERS
TO
QUESTIONS POSED BY THE SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

Responses to Questions Posed by Chairman Jake Garn

1. The (NAIC) National Association of Insurance Commissioners has adopted a Model Unfair Trade Practices Act which requires a lender who solicits insurance to explain in writing to the borrower that insurance related to the extension of credit may be purchased from an insurer or agent of the borrower's choice. In certain circumstances that Act would require that a commitment in writing as to a loan or credit extension be made before the lender may solicit insurance.

Doesn't that type of provision alleviate your concerns about tying sales of insurance to the extension of credit and still allow the consumer to have a broader range of choices available? If so, why can't it be applied to the banks? If not, should the NAIC be tougher and prohibit cross selling?

The primary objective of prospective borrowers -- be they individuals or businesses -- when they present themselves to banks to attempt to secure credit is to be given a loan. The control that banking institutions have over the decision of whether to grant or withhold credit confers upon banks significant leverage over decisions made by prospective borrowers regarding other bank services that might be purchased in conjunction with the loan.

The disclosure requirements that would be imposed upon banks by the NAIC's Model Act are, of course, better than nothing. Nevertheless, those requirements cannot be expected significantly to alter the strong economic and psychological advantage that banks have over prospective borrowers in the context of loan

negotiations. As a consequence, requiring banks to provide written assurances that consumers may purchase insurance from insurers or agents of the borrowers' choice merely adds additional paperwork to already paper-laden financial transactions. Moreover, the additional paper would not guarantee that individuals signing disclosure forms have not been subjected to undue influence by banks in the sale of insurance. In any situation where undue influence has taken place, disclosure documents signed by borrowers could result in little more than make it virtually impossible for any consumer to complain after consummation of a loan transaction that insurance had been forced upon him or "highly recommended" by the bank. Documents contemplated by the Model Act might in some instances, therefore, protect the interests of banks more than consumers.

Moreover, in many cases, it would be difficult to require that discussions about insurance take place only after written commitments to extend credit. In almost all lending transactions where collateral is involved, discussions about the collateral and about how that collateral will be protected by insurance are an integral part of loan negotiations. What is more, the details of how collateral will be insured is information that bank loan committees must have in order to make sound lending decisions. Accordingly, to require that insurance be discussed only <u>after</u> commitments to extend credit could be viewed as a requirement that would be unworkable in many lending transactions.

The danger that tie-ins will occur when sales of insurnce are permitted to take place in conjunction with lending activities has

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been well documented over many years. In January 1984, a group of the insurance agent organizations provided the Federal Reserve Board with comments on the Board's proposal to amend its credit life insurance regulation. Those comments contained a detailed description of the bank-insurance tie-in problem supported specific examples of instances where tie-in sales have occurred in the past. That document is provided as Exhibit 1.

One of the most recent instances where lender-borrower insurance tie-ins have been officially documented involved ITT's consumer finance subsidiary. A Wall Street Journal article describing ITT's tie-in abuses is provided as Exhibit 2.

2. If your concern lies with consumer protection, isn't it preferable to require disclosure of the right to purchase insurance elsewhere and require a loan commitment to be made before insurance is solicited by the lender rather than restrict the consumer's available choices for obtaining insurance?

The control that banking institutions have over decisions of whether to extend or withhold credit confers upon them the opportunity to exert undue influence on prospective borrowers with respect to insurance decisions. Because the need for insurance often arises in conjunction with extensions of credit, banking institutions are uniquely situated to control the decision concerning the source from which insurance is purchased. As a consequence, banks are in a position to prevent normal insurance marketplace forces from operating. By being able to induce borrowers to purchase insurance from them at the time of the loan for reasons that might have nothing to do with lower price or better service, banks have the capacity to fence bank-insurance transactions away from the rest of the insurance market. In that

way, the insurance marketplace where borrowers could normally shop for insurance on the basis of price and service is never given an opportunity to operate. Over the long term, such forces would undoubtedly increase concentration and reduce competition within the insurance industry itself. The only effective way to prevent the anti-competitive forces involved in bank-insurnce transactions from adversely affecting the insurance marketplace is to separate sales of insurance from extensions of credit. Title VI of the Garn-St Germain Act represents a Congressional effort to bring about that result.

3. In the past you have argued that bank sales of insurance present the problem of tie-ins. Recently the U.S. Justice Department's Antitrust Division reviewed this issue and stated:

> **Participation by banking organizations in a broader range of financial activities would be unlikely to result in a significant increase in anticompetitive tying arrangements. The offering of two services or products as a package may represent an economically efficient means of conducting business. Absent market power, a firm cannot restrain competition by such a practice. Given the usual diversity of choices available to the financial services customer, it is generally unlikely that a particular provider of such services possesses the requisite market existing antitrust laws provide adequate protection against anticompetitive ties, whether undertaken by a banking organization, another type of supplier of financial services, or any other type of firm.**

How do you respond?

Despite many changes that have taken place within the financial services industry over the last decade, banks continue to be unique in terms of the role they play in our economy. For that reason, to view the relevant market in which bank-insurance

sales would take place as including other components of the larger financial service industry is unjustified.

Additionally, the Justice Department quotation advocates an unduly broad definition of "market power" in the context of bank-insurance sales. Because of the unique and pervasive function of banks in the economy, the concept of "market power" in respect of bank-insurance sales cannot be viewed broadly. When the average consumer or business goes to a bank seeking credit, few will be concerned about -- or even aware of -- the percent of deposits held by the bank in relation to other banks in the relevant marketplace. What the prospective borrower is concerned about is his ability to secure credit. If borrowers can enhance their chances of being successful in getting credit by purchasing additional services such as insurance from the bank, many consumers will do so. Those decisions are controlled, not by the "market power" of the bank in relation to other banks or other components of the financial services industry operating in the same marketplace, but by the level of desire of the individual consumer to secure credit and by the degree of interest of the bank in making an insurance sale. Whether insurance is tied to extensions of credit therefore is much more a function of the level of desire of the borrower to secure credit and the policies of management concerning how insurance is marketed than it is of other competitive forces within the marketplace.

4. On page 4 of your testimony, you state:

> Bank holding companies are creatures of federal law and once any bank becomes affiliated with a bank holding company, Congress intended that the bank holding company would establish what is appropriate for bank holding companies, not the states.

Are you suggesting that Congressional intent requires any state chartered bank which forms a holding company to divest any activity approved by the state but not approved by the Federal Reserve?

With the enactment of Bank Holding Company Act in 1956, Congress made the fundamental public policy decision to place limitations on the activities that can be pursued by entities that come to control banks. In making that decision, Congress did not sweep away all state participation in the regulation of bank holding companies and their subsidiaries. Through Section 7 of the BHC Act, Congress left to the states the authority to make laws affecting bank holding companies so long as those laws are more restrictive and not less restrictive than the BHC Act. See 12 U.S.C. § 1846 (1982).

Insofar as insurance is concerned, Section 4(c)(8) of the BHC Act as amended by Title VI of the Garn-St Germain Act does not represent an absolute bar to bank holding company insurance activities. The great majority of state banks that might choose to form themselves into bank holding companies would undoubtedly be relatively speaking small banks having total assets of $50 million. Because of the exceptions that Title VI has to the general insurance prohibition, it is likely that such entities would be able to form themselves into holding companies and still continue insurance agency operations initiated under state law.

5. Given the economic pressure which exists for insurance companies to streamline the distribution system and lower distribution costs - other than closing the South Dakota loophole - what recommendations would you have for the Congress which would ease the transition to the financial services industry for insurance agents?

The insurance agency organizations have never recommended that Congress attempt to legislate the activities of the entire financial service industry. To the contrary, the insurance agent organizations have only asked Congress to recognize the potential adverse consequences of permitting large banking institutions which are regulated by federal law, the BHC Act, to engage in a broad range of insurance activities. Congress did that in 1982 when it enacted Title VI of the Garn-St Germain Act. The insurance agent organizations are now merely requesting that Congress comprehensively enforce the separation between banking and insurance that it legislated in 1982 by taking affirmative action along the lines of the Dodd Amendment to prevent circumvention of the law through bank holding company exploitation of a loophole that bank lawyers have proclaimed exists in current law.

6. Isn't it true that bank holding companies are merely registered with the Fed - they are not licensed or chartered by them?

Bank holding companies are chartered by the states, not the federal government. Nevertheless, under the BHC Act, bank holding companie are required to be registered with the Federal Reserve Board. The BHC Act imposes limitations upon bank holding companies with respect to the activities they may undertake. As a consequence, even though bank holding companies are corporate entities that are chartered by the states, the limits of their

activities are prescribed by Congress, not the various states that charter them.

7. If the record were to demonstrate that state chartered banks of holding companies have historically and are currently engaged in activities which have not been permitted by the Federal Reserve Board, would you then agree that the Bank Holding Company Act is intended only to specify the range of activities for subsidiaries of bank holding companies, not to limit the state granted authorities of state chartered banks?

The insurance agent organizations have consistently maintained that the BHC Act does not limit the authority of the states to empower state banks that are not affiliated with bank holding companies to engage in nonbanking activities. What the states may not do under the BHC Act is, through the enactment of state laws, enhance the authority of bank holding companies beyond what was intended by Congress as reflected in the BHC Act. The position of the insurance agent organizations is comprehensively set out in a November 21, 1984 petition which asked the Federal Reserve Board to repeal a regulation which authorizes bank holding companies to undertake through subsidiaries of state banks that are affiliated with holding companies any activity which state law authorizes the state bank to undertake directly. A copy of that petition is provided as Exhibit 3.

8. The Conference of State Bank Supervisors argues that the legislative history of the 1956 Bank Holding Company Act and its subsequent amendments of 1966, 1970, 1980, and 1982 is clear. The concept of the Act was to regulate bank holding companies and not their subsidiary banks. The passage of the Bank Holding Company Act or its amendments was not meant to override the dual banking system. Please find enclosed a copy of a letter from CSBS to the Federal Reserve Board and respond to each point raised in the letter.

While the BHC Act was not intended to override the dual banking system, the Act has always provided careful definition of

the relationship between itself and state banking laws. Specifically, Section 7 of the BHC Act has, since the date of the laws enactment, defined the preemptive effect of the BHC Act. Section 7 forbids the states from enacting laws affecting banks, bank holding companies and their subsidiaries which laws are less restrictive than the BHC Act. In that way, the BHC Act prevents the states from negating the effect of the BHC Act's limitations by establishing more permissive standards.

Far from interfering with the dual banking system, Section 7 of the BHC Act preserves that system. Without Section 7, the Supremacy Clause of the U.S. Constitution would deny the states any authority to enact any legislation affecting bank holding companies having standards different from the BHC Act. Moreover, the meaning of Section 7 of the BHC Act is not susceptible to reasonable dispute -- in Lewis v. BT Investment Managers, Inc., 447 U.S. 27 (1980), the Supreme Court said that Section 7 permits the states to enact laws affecting the components of bank holding companies which laws are more restrictive and not less restrictive than federal law thereby defeating the impact of the BHC Act.

The position of the insurance agent organizations concerning the role of the dual banking system in the bank holding company structure is set forth in a letter that responded to a Federal Reserve Board invitation for comments concerning the authority of the states to empower bank holding companies to engage through state-bank afffiliates in a broad range of real estate activities. A copy of that letter is provided as Exhibit 4.

Questions Posed by Senator Donald W. Riegle

1. In his testimony last week, Secretary Baker proposed that the Bank Holding Company Act be amended in order to give bank holding companies the authority to engage in activities "of a financial nature."

a. What would be the result of such an amendment?

It is the view of the insurance agent organizations that providing bank holding companies with the authority to engage in activities "of a financial nature" would significantly expand the current authority of the Federal Reserve Board to permit bank holding companies to enter upon a broader range of nonbanking activities. Giving the Board such new authority would almost certainly lead to a dramatic expansion of bank holding company nonbanking operations.

From the inception of our national banking laws, the business of banking has been statutorily separated from other forms of commerce. To date, no persuasive case has been made that the current relationship between banking and nonbanking activities needs to be altered significantly. For that reason, the broader authority that would be carried with the "of a financial nature" language advocated by Treasury Secretary Baker is not justified. The current "closely related" to banking standard set forth in the BHC Act provides ample flexibility to permit bank holding companies to pursue limited new nonbanking activities while, at the same time, preserving the longstanding separation between banking and commerce.

b. Do you support such an amendment?

For the reasons set forth in the response to 1.a., the insurance agent organizations do not support such an amendment.

2. The FDIC recently proposed regulations that would permit FDIC-insured banks to sell various kinds of insurance. The FDIC proposal would also permit banks to underwrite life insurance directly and to underwrite property and casualty insurance through subsidiaries.

a. What is your reaction to the FDIC proposal?

The insurance agent organizations believe the FDIC's proposed regulations that would permit FDIC-insured banks to undertake insurance agency activities and life insurance underwriting directly and property and casualty insurance underwriting through subsidiaries is unwise and entirely inconsistent with the longstanding principles which have required the separation of banking from commerce for more than 100 years. The position of the insurance agency organizations with respect to the FDIC proposals is more fully set forth in a letter provided by the insurance agent organizations to the FDIC commenting on the FDIC's proposals. A copy of that letter is provided as Exhibit 5.

b. What issues and concerns do you believe are raised by the FDIC proposal?

See Exhibit 5 referred to in the response to 2.a. above.

3. Concerns have been raised that the entry of banks into insurance agency activities may create the potential for tie-ins between credit and insurance products and may result in giving banks an unfair advantage in marketing insurance.

To what extent do you believe these concerns are valid and to what extent, if any, do you believe they are exaggerated?

The concern that the entry of banks into insurance agency activities would create the potential for tie-ins between the sales of insurance products and extensions of credit is fully justified and overwhelmingly documented in the public record. Exhibits 1 and 2 provided in response to these questions describe in detail how the relationship between a prospective borrower and

lender create an environment where tie-in sales of insurance can occur and provide an abundance of specific examples supporting the view that the concerns regarding tie-in sales of insurance in connection with extensions of credit are well justified.

4. It has been brought to my attention that property and casualty underwriters are beginning to face some real economic problems.

a. Are these reports accurate and, if so, how would you describe the present financial difficulties encountered by property and casualty underwriters?

It would be inappropriate for agents and brokers to question the credibility of their underwriters' own assessment of their financial condition. However, as we understand their situation, hard times have hit the property/casualty insurance underwriters, insurance capacity has been severely restricted in the marketplace, and insurance surplus has been called upon due to unexpected underwriting losses and a lower than expected return on insurer investment income.

b. In light of your assessment, how would you compare the riskiness of property and casualty underwriting to the normal business risk undertaken by a bank?

Property and casualty insurance underwriting involves the assumption of greater risk than the normal business risk undertaken by banks. When a bank makes a loans, the bank's total exposure is known in advance. Moreover, banks can limit risk by requiring an increased level of collateral or by other means. The risk exposure of property and casualty insurance underwriters is much more difficult to assess at the time insurance policies are sold. This is especially true in the current market. Evolving theories of insurance company liability and the increasingly

complex nature of the hazards covered by the property and casualty insurance industry have signficantly increased the riskiness of the property and casualty insurance industry over the last decade. For that reason, in the current environment, the property and casualty insurance underwriting business must be seen as significantly more risk-laden than normal banking operations.

5. I understand that Bank of America recently withdrew its application to acquire a South Dakota Bank that would have been empowered to sell insurance. The Federal Reserve Board had been considering whether such an acquisition is permitted by the Bank Holding Company Act.

In your view, what are the implications of Bank of America's actions?

As far as can be determined, BankAmerica has never fully explained its decision to withdraw its application to establish a South Dakota state bank for the purpose of circumventing the insurance limitations of Title VI of the Garn-St Germain Act. Nevertheless, BankAmerica's action probably had little to do with the legal and regulatory issues presented by its application. It is more likely that BankAmerica's decision was driven by its burgeoning financial problems. On July 17, 1985, for example, BankAmerica announced second quarter 1985 losses of $338 million. A copy of a July 18, 1985 American Banker article describing BankAmerica's financial difficulties is provided as Exhibit 6.

6. We know that banks are interested in engaging in the insurance business and there are indications that insurance companies are interested in the banking business. For example, Prudential recently announced its intent to offer home mortgage loans through its agents.

How do you respond to the argument that banks should be as free as insurance companies to expand their activities?

The insurance agent organizations oppose the creation of circumstances where tie-in sales of insurance can occur, irrespective of how those opportunities might be created or the identity of corporate entities that might benefit from tie-in activities. The insurance agent organizations believe that bank holding companies should be prohibited from engaging in insurance activities in accordance with the limitations set forth in Title VI of the Garn-St Germain Act. Similarly, the insurance agent organizations oppose intrusions upon the banking business by all nonbanking enterprises, including insurance underwriters and securities firms.

7. This question is really unrelated to the subject of our hearing today, but I wonder whether you could take a minute to explain to us the effect on the insurance industry of the President's recent tax reform proposals?

Attached as Exhibit 7, you will find the written testimony of four of the six insurance agent organizations. Each goes into some detail on the effects of the President's tax reform proposal on the insurance industry. The written statements included are those of: Independent Insurance Agents of America, National Association of Casualty and Surety Agents, National Association of Life Underwriters, and National Association of Professional Insurance Agents.

* * *

COMPREHENSIVE REFORM IN THE FINANCIAL SERVICES INDUSTRY

PART II

THURSDAY, JUNE 20, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Riegle, Dodd, and Sasser.

The CHAIRMAN. The Banking Committee will come to order.

This morning we continue our hearings on the oversight of the financial services industry. This will be the last day of hearings.

In order to save time, I will simply place my opening statement in the record.

OPENING STATEMENT OF SENATOR GARN

This is the last day of hearings scheduled to oversee developments in the rapidly changing financial services industry. Having heard from other competitors in the industry, last but not least, we are privileged to receive an update of the points of view of various segments of the investment banking community.

The issues that have been discussed here in the last 2 months have involved revolutionary changes in an industry central to the health of the entire American economy. Not least among these is the continued applicability of the Glass-Steagall Act, now in excess of 50 years old, to activities not even contemplated in the 1930's.

The title of last year's bill, the Financial Services Competitive Equity Act, belies my predisposition to ensure a high level of competition between different portions of the financial services industry. I know it comes as no surprise to my friends in the securities industry. As a former mayor, I know of the cost savings that would have been realized in municipal finance if there had been more competition for underwriting business.

I am also aware of the inclination of those who historically have been in the securities business to seek access to the payments system by entering the banking business. Each of the corporate witnesses appearing before us today has a nonbank bank charter, admittedly one of which dates back to 1972, each of which will be

grandfathered under the bill approved by the House Banking Committee.

The future shape of the financial services industry is crucial to the health of our economy. These are not issues we can consider lightly. I know that our witnesses have given these matters a lot of thought and have taken a great deal of time to give us the benefit of their thinking. I welcome them to our committee.

I will try to keep the introductions as brief as possible. On our first panel, we have Jim Robinson, chairman of American Express, William Schreyer, chairman of Merrill Lynch, and Robert Linton, chairman of Drexel Burnham Lambert, Inc. The second panel will include Robert Shapiro, chairman of the Securities Industry Association, and David Silver, president of the Investment Company Institute.

Let me remind each of you gentlemen of our procedures. After all members of a panel speak, there will be a question and answer session. Do not be afraid to abbreviate your comments, as your full written statement will be included in the record. The committee may submit additional written questions to you for the record after the hearing is completed.

Senator D'Amato.

STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Good morning, Mr. Chairman. Before I begin I would like to welcome the panel of witnesses here today and commend you for conducting this series of hearings. I would especially like to welcome Mr. James Robinson of American Express, Mr. William Schreyer of Merrill Lynch, and Mr. Robert Linton of Drexel Burnham Lambert, Inc., all New York State constituents of mine. I am certain their testimony will be most informative.

Banks were given Federal deposit insurance in 1933 to provide a stable foundation for our financial system. I don't believe the idea of banks reentering the securities business was even contemplated in 1933, since deposit insurance insulated them from market discipline. The Federal Government, as the backstop to the FDIC, was not expected to foot the bill for risky activities of banks. Banks, are increasingly becoming involved in the securities business, a business which I believe is riskier than most banking activities.

Bank involvement in the securities market is just one of the problems facing the banking industry, which is showing increasing signs of strain. This set of hearings presents the proper forum to acquire the information needed to develop comprehensive legislation. Through this set of hearings many of the problems facing the industry can be solved.

Thank you, Mr. Chairman.

The CHAIRMAN. I'm very pleased to have a distinguished group of panelists in two panels that we have today. First, Mr. James D. Robinson III, chairman and chief executive officer of American Express Co.; William A. Schreyer, chairman of the board, chief executive officer of Merrill Lynch; Mr. Robert E. Linton, chairman, Drexel Burnham Lambert, Inc., of New York.

Gentlemen, we're very pleased that you would be willing to testify today.

Mr. Robinson, if you'd like to begin.

STATEMENT OF JAMES D. ROBINSON III, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, AMERICAN EXPRESS CO.

Mr. ROBINSON. Good morning, Mr. Chairman. Thank you. This is my third appearance before your committee in 4 years, and while I like to think of myself as broadminded and openminded, my views pretty much remain unchanged.

So I'm delighted to have a chance to present them again. If you're not tired of listening, I'm not tired of presenting.

The CHAIRMAN. Well, my views haven't changed much over the years, either—[laughter]—after listening to thousands of pages of testimony. So we're both in the same boat.

Mr. ROBINSON. All right. Well, let me give you my bottom line at the outset, and then go into some of my reasoning.

I think the best world is one where separate subsidiaries of financial companies are fully regulated by function and where holding companies, with appropriate constraints, can enter into various elements of the financial services industry.

REVIEW AND MODERNIZE THE LAWS

Having said that, I'd like to trace the logic that brings me to those conclusions. In general, as I've stated before, and I will be repetitive here, I believe Congress should review and modernize the laws governing our financial system according to the following benchmarks.

One, a safe and sound banking system should be assured.

Two, innovation, especially technological innovation, should be actively encouraged.

Three, the marketplace should be permitted creativity and efficiency, assuming suitable safeguards.

Four, the regulations should allow a diversity of both large and small financial institutions.

Five, reform should not weaken appropriate protections against conflicts of interest, self-dealing, and abuse of customer funds.

Six, of course, we must maintain a strong and independent Federal Reserve System.

Today we find a financial system that is substantially different than it was 50 or even 10 years ago, and it's still evolving. Increased competition, innovation, technology, deregulation, economic uncertainty, and enlightened consumers have produced profound changes.

Mr. Chairman, I believe the ongoing battle between groups of institutions, understandably seeking additional powers and competitive advantage, is being waged without sufficient regard for the interests of the consumer. In fact, the consumer is in danger of being forgotten or ignored.

So this morning, I'd like to ask why this is happening. Second, I'd like to encourage some fresh thinking about what the public wants and needs. And finally, I'd like to make a few suggestions as how best to serve the interests of the public over the longer run.

First, why is the consumer interest in financial services often subordinated to special interests?

The main reason is that too much time is spent arguing about institutional turf, about institutions and rules that were invented long before technology and the modern consumer responding, of course, to double-digit inflation, revolutionized the world of finance. And too much energy is devoted to preserving existing institutional distinctions or to trying to balance their powers to construct a theoretical level playing field. In trying to achieve a competitive equilibrium, we lose sight of whether a particular regulatory regime helps or hurts the consumer, whether it promotes or stifles competition, whether it encourages or discourages innovation, and whether it truly assures safety and soundness in the system.

Mr. Chairman, as my second point, I believe Congress should take a fresh look at our overall financial system from a much broader perspective. We need a comprehensive, forward-thinking appraisal that focuses on long-range public needs and national requirements. Such an examination should not be defined or constrained by the vested interests of in-place institutions. Instead of focusing on the present functions of particular and existing institutions and industries, we should be looking at the overall objective of public policy. In other words, what do you really want to achieve?

During the last half-century, the timing and content of landmark financial legislation has often coincided with Congress' need to address major crises. Often short-term exigencies rather than longer term vision has shaped our judgments and our financial systems. Crisis management isn't the answer.

I'm not calling for another Presidential commission or yet another round of congressional hearings that would simply catalog the well-known views of existing institutions. We've all heard that perhaps too many times.

REFOCUS ON THE FORGOTTEN CONSUMER

I am suggesting that we refocus the debate on the essential needs of the forgotten consumer, that we look beyond what is good for specific existing industries, institutions, or regulatory agencies. We should concentrate on choices. They should be maximized. Credit should be available and at reasonable cost for all Americans. And on the essential safety and soundness of the financial system which must, of course, be assured.

Now these essentials aren't new. Long ago, to ensure them, the Government struck a bargain with depository institutions, banks and thrifts. For instance, the Government agreed to provide Federal deposit insurance at very low cost. In turn, the banks and thrifts agreed to serve the entire community and avoid engaging in excessively risky activities. Other nondepository financial institutions do not receive such special treatment. That's fine because they are allowed to take greater risk.

One might raise the question of whether that essential bargain of deposit insurance for serving the public is being honored today. Many depository institutions are engaging in new, riskier, and sometimes even speculative types of activities with their insured deposits and other Government-created advantages.

Let's look at the basic bargain of access in terms of choices. In one sense, of course, many consumers, particularly the middle class and affluent, have more choices than ever before. That's great, but some consumers are actually losing access. We've all read about how certain banks have tried to force low-income customers to use teller machines and how they've raised the fees for a variety of services for these customers. They, of course, are zeroing in on middle and upscale markets.

If banks and thrift institutions want to practice fee enterprise in the name of free enterprise and target the affluent, that, of course, is their right. But then, perhaps they should take a razor blade and scrape the deposit insurance stickers off their windows.

Now the second element of the old bargain is credit availability. The Government, as a matter of policy, attached a high priority to moving credit into housing and small businesses in local communities. Are today's depository institutions meeting that part of the bargain?

For instance, thrift institutions have actually been moving away from housing for a decade, and few people realize that about half the money going into mortgages is brokered out to other institutions in the form of mortgage-backed securities.

That's a great innovation. It's helped create liquidity for a number of thrifts. But many have used the funds to diversify even further away from housing. So if too many thrifts direct their energies away from the homeowner, another group of consumers is in danger of being forgotten by the very institutions designed to service it.

Now, of course, I'm not opposed to such diversification, but then, why not let others, ready to serve those markets, come in? Wouldn't it be better for the Federal Home Loan Bank Board to concern itself with how to attract the greatest amount of capital to the home mortgage market?

Now the third part of the old bargain is safety and soundness. And traditionally, certain barriers have existed to make sure that depository institutions remained on firm ground. Banks were not allowed to underwrite or to insure. Thrifts were not allowed to become involved with commercial enterprises.

But all of that has been changing. Thrifts, for example, are becoming more involved with commercial loans and with equity in commercial enterprises that, by definition, are riskier than housing loans.

I'm not saying this is wrong, as long as the basic bargain is being fully kept. Unfortunately, I don't think it is in many cases.

FEDERAL INSURANCE IS NOT A TRAMPOLINE

Mr. Chairman, Government deposit insurance is intended to be a safety net, not a trampoline. It was not designed to allow bankers to bound into new areas of business away from their special role in the economy. It was not designed so that the U.S. Government would become a partner in marketing—and incidentally, the one that bears the downside risk.

Let me turn now to a few suggestions.

We want to encourage innovation. Money market funds and financial management accounts, for example, were the heroes of the forgotten depositors in the 1970's. And who knows what the heroes of the late 1980's will be?

If we still have them, one possibility would be consumer banks, banks that accept deposits and make loans to individuals, but not to businesses. Of course, the consumer bank already exists. It represents a clear institutional choice.

Now, unfortunately, it's been named nonbank bank and it's got a number of detractors. But I've yet to hear a cogent argument of just what's wrong with it. Incidentally, nonbank banks are the consumer equivalent of bank entry into discount brokerage. Should they be called nonbroker brokers?

To restate my principal suggestion about functional regulation: upon analysis, I suspect we would find that regulation of separate subsidiaries by function—securities underwriting, insuring, deposit taking, brokerage, and so forth—would serve national priorities better than regulation by institution.

The administration's legislative proposals and the Garn bill drawn from them make important conceptual headway toward functional regulation, by using separate subsidiaries as the instrument of deregulation and diversification for depository institutions and their holding companies. This modular approach could be expanded to apply to diversification by all financial intermediaries as not only the fairest means to promote competition, but also the fastest, because it builds upon an existing and established regulatory framework already in place.

Mr. Chairman, my prepared remarks contain a discussion in further depth of these issues and of the international dimensions. I'll not repeat them today, but I'll be glad to respond to any questions.

Thank you for this opportunity.

[The complete prepared statement follows:]

TESTIMONY OF JAMES D. ROBINSON III
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
AMERICAN EXPRESS COMPANY

CHANGES OCCURRING IN THE
FINANCIAL SERVICES INDUSTRY

Mr. Chairman, and distinguished members of the Committee, I am pleased to appear before you again. This is my third appearance before the Committee over the last four years. My views today remain unchanged during that period and I would like to reiterate them. As I have stated before, I believe Congress should review and modernize the laws governing our financial system according to the following benchmarks:

- A safe and sound banking system should be assured.
- Rules which are outdated and stand in the way of innovation -- especially technological innovation -- should be modified.
- The marketplace should be given the broadest ability to be creative and efficient -- assuming suitable safeguards.
- The regulations should allow a diversity of both large and small financial institutions operating in this country.
- Reform should retain protection, when appropriate, against conflicts of interest, self-dealing and abuse of customer funds.
- We must maintain a strong and independent Federal Reserve System.

This morning I want to offer additional observations about the complex changes occurring in the financial services

industry. In addition I want to endorse and recommend the principles of "functional regulation" by separate subsidiary, that in my view is the ultimate, although politically difficult, objective.

Mr. Chairman, above all, I want to look beyond parochial interests and immediate legislative controversies and talk about the broader and -- I think -- the bedrock policy issues and questions that Congress must address. I believe Congressional action is needed to ensure the continued preeminence of our financial system, financial services organizations and our capital markets in an increasingly competitive and interdependent world. We face challenges at home and abroad.

At home, our once carefully designed, intentionally segmented and heavily regulated financial system has already changed substantially. The confluence of increased competition, innovation, technology, deregulation, economic uncertainty, and enlightened consumers have produced profound changes in both the consumer and institutional financial markets and financial intermediaries. Any resemblance to their ancestors of the 1930's -- or even of the 1970's -- is remote.

Neither American Express nor the other companies which have appeared before the Committee have been the principal creators of the revolution we are experiencing. We can't claim that. The chief provocateur for these massive changes is the consumer--the average individual, the saver, the investor. It is our customers and your constituents. We in the financial services industry are responding and reacting to fundamental changes in once relatively quiescent investment and savings patterns. In the final analysis, consumers and consumers alone will determine the ultimate success and merit of the new financial products, services and delivery systems that financial service industry providers will create.

Mr. Chairman, of course, the appropriate role of Congress in the midst of this dynamic process is to define the proper regulatory regime. Ideally, the legislative framework would allow a prudent and proper mixture of market-determined competition and innovation with a degree of regulation necessary to protect consumers and to effectuate public policy. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, eloquently and succinctly described the task ahead for Congress as follows:

> ...the thrust of deregulation in banking and finance should be viewed as the effort -- a very difficult effort -- to tailor our laws, our regulations and our supervisory efforts in ways that best capture the benefits of more efficient markets while preserving a safe and sound financial environment...

Mr. Chairman, I suspect that to a great extent consumers of financial services are in danger of being forgotten in the battle between groups of institutions seeking additional powers and competitive advantages. So this morning:

- I would like to ask why this is happening;
- Secondly, I would like to encourage some fresh thinking about what the public wants and needs;
- Finally, I would like to give my observations of what may be in the best interests of the public in the long run.

First, why is the public interest in financial services often subordinated to special interests? The main reason is that too much time is spent arguing about <u>institutional</u> turf--institutions and rules that were invented long before technology and double-digit inflation revolutionalized the world of finance. Too many decisions are based on what is good for a certain type of existing institution in terms of what additional powers that institution should have; and not enough on what new institutional structures would be best for the consumer and for the country. By concentrating too much on preserving existing institutional distinctions, by trying to balance their powers, we sometimes lose the broader focus on whether a particular regulatory regime helps or hurts the consumers, promotes or stifles competition, encourages or

discourages innovation, and whether it maintains safety and soundness in the system.

The arbiters of change -- the institutions, the regulatory agencies -- haven't been able to focus on consumers' needs and safety and soundness because they have been too busy focussing on institutional clashes. This is not surprising since their focus has been oriented to the past and present -- and not sufficiently to the future.

The result is an accumulation of crisis to crisis ad hoc legislative and regulatory judgments. Some of these judgments were taken during period of crises, and properly so. But we can no longer be confident that crisis management and ad hoc decisions add up to a coherent whole or relate to the central and overriding purpose of serving the public interest. In many cases, they do not.

The regulatory authorities -- experienced people trying to properly discharge their responsibilities -- are in an untenable position. Unfortunately, they're condemned to enforce rules governing a financial world that no longer exists. They themselves recognize the folly of the system and are pressing Congress to sort out the rules. They are in a bind because they must defend the interests of the consumer,

while at the same time protect the turf of their own institutional constituents.

Mr. Chairman, I believe Congress needs to take a fresh look at our overall financial system, and that's my second point. We have all been in situations where prompt decisions were a necessity and I am not critical of past decisions. Today we have no real or immediate crisis and we can therefore afford to take a deliberative approach.

In my judgment, the debate has been directed at the wrong questions -- about defending turf, about defending specific industries or institutions by trying to create a mythical "level playing field", saving the very life of particular industries that have fallen on hard times; or by adding powers to some institutions, then trying to balance it later by adding powers to other institutions; and so on.

As I have indicated to the Committee on previous occasions, I believe the right questions are about public policy concerns, such as:

- The breadth and liquidity of our money and capital markets;

- The ability of the Federal Reserve to execute effective monetary policy;
- And how institutions can best intermediate the nation's savings.

Mr. Chairman, we need a broad, forward-thinking appraisal that focuses on long-range public needs, an examination that is not defined by the vested interests of in-place institutional management, nor burdened by the weight of in-place infrastructure that makes up our present system. I suspect most would agree that regulation or advantage should not be determined byinstitutions that complain the loudest, have the largest trade associations or are in the greatest trouble. Instead of focusing on the functions of particular and existing institutions, we should be focusing on these appropriate objectives of public policy.

I am not calling for another presidential commission or yet another round of Congressional hearings that would simply catalogue the well-known views of existing institutions. We've all heard that chorus, probably too many times.

Today, my focus is on public policy concerns that relate to the consumer. What does the forgotten consumer need and want?

- One need is access to the broadest array of financial services ... choices;
- A second is credit at reasonable cost for all Americans; and
- A third is the essential safety and soundness of the financial system.

Mr. Chairman, analysis of the history of federal and state efforts to regulate the financial system reveals how enduring these consumer-oriented principles are. The government, in an attempt to provide these three essential elements, long ago struck a basic bargain with depository institutions -- banks and thrifts. In exchange for helping guarantee these three elements -- access, reasonable cost of credit, and safety andsoundness -- the government agreed to grant these institutions special treatment. This special treatment includes Federal deposit insurance for banks and thrifts at very low cost in exchange for serving the entire community and in exchange for not engaging in excessively risky activities.

Other non-depository financial institutions, like American Express, do not receive such special treatment. That's fine. We're empowered to take greater risks. But my question is whether that essential bargain of deposit insurance for serving the public is being respected as depository institutions engage

in new, riskier and sometimes even speculative types of activities with their insured deposits and other government-created advantages.

First, look at the question of access. In one sense, of course, many consumers, particularly the middle class and affluent, have more choices than ever before. They can conduct financial transactions 24 hours a day with cash machines. They can select from an array of financial instruments -- whether it be NOW accounts, money market funds or money market deposit accounts. And they can conduct most financial transactions with their banks or their brokers or even in their department stores.

But some consumers are actually losing access. We've all read how certain banks have tried to force lower-income customers to use teller machines and how they have raised the fees for a variety of services for these customers. This is all part of an attempt by these banks to zero in on middle and upscale markets.

Incidentally, a healthy piece of bank and thrift earnings for many years came from these same depositors who are now being squeezed out, from the same depositors who for years were forced by regulation to accept only a 5 percent return on their passbook savings.

If banks and thrifts institutions want to practice "fee" enterprise in the name of "free" enterprise, and target the affluent, that's their right, of course. But then perhaps they should take a razor blade and scrape the deposit insurance stickers off their windows.

The second element of the old bargain is credit availability. The government, as a matter of policy, attaches a high priority to moving credit into housing and small businesses in local communities. But the question has been raised whether depository institutions are meeting this part of the bargain.

For instance, thrift institutions have actually been moving away from housing for a decade. Few people realize that about half the money going into mortgages is brokered out to other institutions in the form of mortgage-backed securities. That's an exciting innovation, but it means many thrifts have diversified away from their basic charter of housing mortgages. In fact, from 1980 to 1982 the mortgage holding of thrifts declined by $20 billion while their loans in other areas increased $70 billion. So if the thrifts are directing their energies away from the homeowner, another group of consumers is in danger of being forgotten by the very institutions designed to service them. Of course, the power to divert these energies arose from a crises in the thrift industry when the Congress

empowered the thrifts to diversify. I'm not opposed to such diversification, but, then why not let others ready to serve that market come in?

The third part of the old bargain is safety and soundness. Traditionally, certain barriers have existed to make sure that depository institutions remained on certain firm ground. Banks were not allowed to underwrite or insure. Thrifts were not allowed to become involved with commercial enterprises.

But all of that has been changing. Banks are breaking down the barriers to engage in insurance brokering, insurance underwriting and stock and bond sales. Thrifts also are becoming more involved with commercial loans and with equity in commercial enterprises that by definition are riskier than housing loans. While this liberalization is occurring at the Federal level, many states are engaged in a footrace to see which can deregulate state-chartered entities the furthest and the fastest, sometimes authorizing powers impermissible under Federal law. In California, for example, S&L's can channel virtually all their assets to service companies which can buy stock of individual companies, and speculate in junk bonds. These activities are far removed from financing home ownership.

Mr. Chairman, there's no doubt in my mind that government deposit insurance is intended to be a safety net and not a trampoline. It was not designed to allow bankers to bound into new areas of business away from their special role in the economy. It was not designed so that the U.S. Government would become a silent partner in marketing and the silent and frequent junior partner that bears most of the downside risk.

Let me be clear on this important point. Mind you, I am not proposing that we prevent banks or thrifts from engaging in new activities. I am only questioning the government's role -- as insurer, and hence, partner. I think the deposit insurance schemes need a complete rethink. And I would add that we need a rethink of the corporate governance rules applying to depository institutions -- including liabilities of directors, the functions of outside audit committees of the board of directors, and so on.

Let me turn to a third and practical point: specifically, what steps should Congress take to ensure that the public interest is served now and in the future?

We should take a look at existing institutions to see if they still fulfill their original purpose and to determine if they should continue to enjoy their special privileges. If

they don't meet the original purpose test, perhaps other institutions or new institutions -- should be encouraged or at least have the opportunity to step in.

To serve the forgotten consumer, we want to encourage innovations. Money market funds, for example, were the heroes of the forgotten depositor in the 1970's by giving the individual savers money market rates for the first time. And who knows what the heroes of the late 1980"s will be? If we still have them, one possibility would be "consumer banks".

The creation of a "consumer bank" is a possibility -- banks that accept deposits and make loans to individuals, but not to businesses. The consumer bank already exists, unofficially, as the poorly and unfortunately named "non-bank bank." And it has many detractors. But I have yet to hear a cogent argument of just what's wrong with the principle of banks limited to non-commercial loans. Perhaps we should think about pulling it out of regulatory limbo and formally ratifying its existence as a consumer bank in response to a genuine consumer demand for such entities.

Consumer banks are pejoratively referred to as "non-bank banks". But if we are to use semantically slanted names for

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such institutions, perhaps the very large banks which have gone into discount brokerage should be called the "non-broker brokers".

Lastly, we should consider the role of regulators. Do we really need as many federal regulatory agencies as there are now? Or would the public interest be better served if authority was consolidated in a fewer number of agencies unencumbered by traditional viewpoints?

We might find that regulation of separate subsidiaries by function -- securities underwriting, insuring, deposit-taking, brokering etc. -- may serve national priorities better than regulation by institution. The Administration's legislative proposals and the Garn bill drawn from them made important conceptual headway toward "functional regulation" by using separate subsidiaries as the instrument of deregulation and diversification for depository institutions and their holding companies. This "modular" approach could be expanded to apply to diversification by all financial intermediaries as not only the fairest means to promote competition but also as the fastest because it builds upon an existing and established regulatory framework.

If it is impractical or unwise to return to the carefully segmented institutions of the past, and the present ad hoc addition of powers in lieu of painful tinkering with the status quo is inadvisable -- which I think it is -- then the sooner we get on with thinking through a comprehensive approach, the better.

We already have regulation by function to a great extent. The discount brokers owned by bank holding companies are regulated by the SEC. Non-bank banks owned by others are nevertheless regulated by the FDIC and the Comptroller, or state authorities. Insurance subsidiaries of all are regulated by their traditional state regulators. And so on.

Lastly, we should ask whether a given regulatory body is doing what it really is designed to do. Is the Federal Home Loan Bank Board, for example, really doing the best job in funneling funds to the housing sector, from all sources, not just from thrifts? That was, and remains, its principal objective. Isn't it interesting that as the thrifts are leaving their traditional activities in the housing markets, other entities, including my company, are finding it profitable to get into the business -- though with no help or encouragement from the Federal Home Loan Bank Board. Incidentally, while the Federal Home Loan Bank Board has the authority under

Garn-St.Germain, it has unilaterally prevented non-industry sources of home financing from competing. This is a classic example of turf protection vs. consumer protection.

Mr. Chairman, my last point this morning concerns the international aspects of the trends and developments we are discussing. We should recognize the globalization of the financial services marketplace as inevitable. Major financial markets are becoming more closely related, more interactive and more interdependent. As New York Federal Reserve President Corrigan acknowledged recently in a speech to foreign bankers,

> ... "over time, there will have to be some greater convergence in thinking about financial market developments and structure among officials in the major industrial countries of the world. In the near term, greater attention and effort will have to be devoted to achieving a higher degree of coordination in cross-border supervisory efforts ... ."

Mr. Chairman, the point is that the United States is not alone in either the problems it is experiencing or the solutions we are developing. The blurring of financial industry distinctions experienced here is also evident in Western Europe, Canada, Japan and Australia -- in fact, throughout the industrialized world. It is a global phenomenon. For example:

- In Britain. The distinctions among the pillars of the financial establishment are disappearing. Banks, building societies, assurance companies and securities

firms are starting to compete with each other for the first time as the City of London moves toward a deregulated environment.

- We see the beginnings of the same phenomena in Australia. The building societies have begun offering ATM systems in competition with the banks. The stock exchange also is headed for profound changes as more commissions are negotiated.
- In Canada. The government is allowing the banks to offer discount brokerage services. The lines among banks, trust companies, insurance groups, and securities houses are becoming obscured.
- And we are definitely moving toward a global securities environment, further internationalizing the world's financial markets.

The world is truly becoming one electronic village and global trading and global financial markets have arrived. In the rapidly changing world economy, we should not underestimate the threat to the historic preeminence and leadership of our economy and capital markets that will be mounted by aggressive foreign countries and institutions. We must therefore be mindful of the international dimensions of the issues before the Committee and fully aware that the implications of Congressional actions will reach far beyond our borders.

Mr. Chairman, I genuinely hope that my message this morning is helpful to you and your colleagues as you continue your efforts to reassess public policy and modernize the laws governing our evolving financial system.

The CHAIRMAN. Thank you, Mr. Robinson. Mr. Schreyer.

STATEMENT OF WILLIAM A. SCHREYER, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, MERRILL LYNCH & CO., INC.

Mr. SCHREYER. My name is William A. Schreyer. I'm chairman and chief executive officer of Merrill Lynch. I appreciate the opportunity to testify here today and exchange views on the future of the Nation's financial services industry.

I will make a brief presentation summarizing my prepared statement, hopefully leaving ample time for any questions that you may have.

Before I begin, Mr. Chairman, I would like to take this opportunity on my first appearance before this committee to make a few general remarks.

These are exciting and challenging times in all quarters in America. Nowhere is that more true than in the financial services industry. The rapid innovation and expansion from stocks and bonds to a literal plethora of products from our domestic economy to a global market makes your job and mine challenging and certainly formidable.

As such, I want to offer, and I'm very sincere and serious about this, any assistance that I or my firm can provide. I'm quite proud of the people at Merrill Lynch—our analysts, economists, attorneys—even attorneys—and account executives. And I will ensure that they are available to your committee if they can help.

WORK TOGETHER FOR FURTHER DEREGULATION

I believe that the only rational way to further deregulate the industry and accommodate the international and technological innovations pushing it along is for us to work together, not as adversaries, but to the extent possible as consultive partners. Clearly, we will not always agree. We will independently reach conclusions. But even if we do not agree, I promise to always give you the best insights, opinions, and analysis that I or my firm can offer.

Before I begin, I want to say parenthetically that I took the opportunity to review my predecessor's testimony before this committee—that of Roger Birk in June 1983, just almost 2 years ago, June 23. I'm happy to say, even though I conducted this review after my testimony was drafted, that our position remains essentially unchanged, although I emphasize different issues because the environmental, especially the regulatory environment, has changed somewhat.

We were then, as we are now, in favor of the rational deregulation of financial markets to meet the needs of financial consumers. I'm honored to have this opportunity to discuss the financial services industry and, in particular, the issues being considered by this committee. And I am pleased to have a chance to say a few words on behalf of deregulation in our industry, which has brought American consumers such enormous benefits.

Before deregulation, as you know, bank depositors were limited largely to passbook accounts at a fixed rate of interest, fixed below market and subject to the erosion of inflation, I might add.

Today, by contrast, the customer can obtain a variety of savings accounts and shop around for the desired terms and best yields. We believe that competitive pressure from the securities industry money market funds play a key role in helping financial consumers gain access to market rates at their banks and their thrifts, thus encouraging savings and enhancing capital formation.

Similarly, today's customer of a broker has a much greater range of opportunity and choice. Until May 1975, commission rates were fixed and investment opportunities generally were limited to the traditional stocks and bonds. Today's brokerage firms, by contrast, offer varying commission rates, flexible services, and a wide variety of investment products.

Overall, the financial services industry is still evolving and the users of financial services are enjoying the benefits of competition, including greater price competition, wider choices, and a greater array of products and services than ever before.

What prompts me to speak today is my conviction that any legislation should continue promoting fairness in competition and my desire to encourage this committee to preserve and extend the gains brought about deregulation.

In some cases, unfortunately, it seems as if proposed legislation might not serve this end and might, indeed, turn back the clock. One such example is the restriction being considered on the limited service bank, the popular nonbank bank.

I regret to say that the House Banking Committee seems to see these banks as a threat to the financial system, either as an end run around the restrictions on interstate banking or as a dubious legal device to get a toehold in commercial banking.

Well, I'd like to set the record straight as far as we're concerned.

Our limited service bank is simply a means for us to deliver vital transaction services to our regular customers. In order to compete, we must be able to offer these important services only a bank-like facility can provide.

Specifically, our bank gives us access to the Fed for processing our Government securities business. It gives us access to the Fed payment system and membership in VISA for processing transactions for our cash management accounts. It gives us a transfer agent and registrar for our mutual funds business. It gives us the ability to offer certain trust services that some States require be handled by a bank.

In short, our limited service bank is simply a means for us to run our business as effectively and efficiently as we can. It's difficult to conceive how these limited services constitute a threat to the banking industry.

So I say to the members of this committee, we don't want to become a commercial bank and we have no plans to compete nationwide with the commercial banks. What we want is to be able to perform in our limited service facility for our customers the important functions that I've just listed.

A second issue is the matter of brokered deposits. In this case, a flourishing market has developed as a result of deregulation. It matches thousands of savers with banks seeking deposits. It has brought savings opportunities to individuals and access to wider pools of capital for depository institutions. Yet, here, again, there

are those who say that this market threatens the banks, the Federal deposit insurance fund, and our financial system. And, here again, I believe that the record should be set straight.

This market is a prime example of market demands creating valuable services. It's a convenience for individual savers, a reliable source of funding for banks and thrifts, and a healthy step in the evolution of our financial services industry.

APPLAUD EFFORTS TO CURB ABUSES

As a firm that thoroughly evaluates the creditworthiness of the banks and thrifts whose CD's we sell, Merrill Lynch is well aware of the potential abuses that brokered deposits can pose. That is why we applaud efforts such as this committee's that are aimed at curbing those abuses while preserving deposit brokerage for sound institutions.

Curtailing excessive growth of brokered deposits in weak institutions is desirable. But while doing so, legislation must protect this free market and confirm the right of sound depository institutions to utilize brokers as part of a prudent plan of attracting deposits.

In summary, let me note that back in the 1930's, our banking and financial system faced disaster. After comprehensive review of the situation, Congress passed the Glass-Steagall Act and other measures which have stood for over 50 years. Today, there are some who advocate undermining Glass-Steagall and some who are ready to dismantle it piece by piece.

The problem with these approaches is that they aren't based on a comprehensive review of the consequences—the potential for abuses, the higher levels of economic concentration, the unfairness that haphazard repeal might bring.

This committee has an opportunity to encourage fair competition, to let Americans themselves choose the institutions that deliver the services that they want, to preserve the safety and soundness of our financial system, and to ensure American consumers a wide range of products and services.

Our position on these issues, therefore, is as follows:

On limited service banks, we deserve the right to continue using these facilities to provide our customers the finest services we can.

On brokered deposits, we support this committee's constructive approach. Limitations on short-term deposits to weak institutions, but preservation of prudent growth to sound depositories.

On Glass-Steagall, we oppose piecemeal dismantlement and favor a comprehensive congressional study on the potential consequences of repeal, such as undue economic concentration and conflicts of interest.

On regulation, it should ensure competitive equality and be functional in nature; that is, securities activities should be regulated by securities regulators whether or not engaged in by a securities firm and banking activities by a banking regulator.

On interstate banking, with both Houses of Congress split and the courts examining the issue, we recognize only that pressures will continue to increase to permit such expansion. Our own banking goals are limited to that single facility in New Jersey.

On proposed legislation, this year's House bill is troublesome. It would destroy years of planning and improvements that we have made on behalf of our customers. Last year's Senate bill, with its July 1983, grandfather date, would, unfortunately, have the same effect.

On consumers, we believe the choice should be theirs; and on competition, we're all for it.

If I could leave you with one message today, it would be that we urge you to allow market forces, shaped by responsible and equal regulation, to provide the kind of financial services the American consumer wants and deserves.

Thank you very much and I'll be happy to answer any questions later on.

[The complete prepared statement follows:]

STATEMENT BY

WILLIAM A. SCHREYER

CHAIRMAN AND CHIEF EXECUTIVE OFFICER

MERRILL LYNCH & CO., INC.

My name is William A. Schreyer; I am Chairman and Chief Executive Officer of Merrill Lynch. I am pleased to be here today to talk about the financial services industry. I would like to address the following points:

1) The pressures for change in financial services have resulted from increased consumer demand and sophistication, inflation and inflationary expectations, and technological innovation.

2) Intense competition has benefitted customers by providing them with greater choice, higher returns, a variety of services and innovative packaging of products. The ability of regulated brokerage firms to sell CDs of creditworthy banks and thrifts is but one example of customer opportunities which need to be preserved.

3) "Nonbank banks" are a logical and useful development in the evolution of financial services. Restricting their use by legitimate providers of financial services would serve only to increase the cost and reduce the quality of services available to consumers. Equality of opportunity is very important to the future success of the financial service industry. Securities activities of banks cannot be expanded at the same time multi-service broker/dealers are denied the ability to deliver limited banking services to their customers.

I will close with some thoughts on the subject of deregulation and share with you my opinion on the objectives of regulation of financial services.

1. Evolution of the Financial Services Industry. We are all familiar with the events of the late 1920's and early 1930's that led to the enactment of our securities and banking laws. The stock market crash, the bank failures and the resulting Great Depression were events that seared the national consciousness. The legislation that separated commercial and investment banking, established deposit insurance, and created the Securities and Exchange Commission to regulate the issuance and trading of securities, were reasoned responses to serious abuses and weaknesses in our financial system. The system of separation of banking and commerce and banking and securities has worked well. Lately, though, it has suffered serious strains as a result of circumstances the drafters of the original legislation could not have foreseen.

One of these was double digit inflation. During a period of deflation, such as the 1930's, few people could conceive of or plan for the consequences of a period of virulent inflation. Commonly accepted practices such as interest rate ceilings, fixed rate mortgages and long-term financing became disastrous to those unable or unwilling to accept that times were changing rapidly. With rampant inflation,consumers demanded new investment vehicles and new and faster ways of moving their money and getting access to it. Innovations such as money market funds with checking privileges, Merrill Lynch's Cash Management Account, and

bond funds were the result of consumer demands for better service. Consumers attracted by greater convenience have eagerly responded to discount brokerage services made available to them at banks and thrifts.

The second element driving change is technology. Computers and high-speed communications devices have revolutionized financial services, from automatic teller machines to the NASD's Automated Quotation Service. They have allowed institutions to transfer funds and raise money anywhere in the world. Consumers have information about their bank and securities accounts at their fingertips and can have their instructions carried out instantly.

Given these pressures, it is no wonder that the lines drawn by the banking and securities acts have become blurred. Consumers no longer are captive accounts of institutions but can move quickly and easily to wherever rates or services are superior. The competition for the consumer's business has become intense and will continue to be so. Even though inflation has receded from the destructive levels of a few years ago, the lessons learned from that experience are still with us. The consumer's demand for services and the uses of technology has had a significant impact on delivery of financial services. Merrill Lynch has itself shifted from a products orientation to one which is market driven.

The competition among financial service companies has offered the consumer an unprecedented choice of products and services. For us, competition is no longer limited to organizations such as Salomon Brothers and Paine Webber. We are also competing with Citicorp, Sears and American

Express. It doesn't mean that we can - or want to - do everything that those institutions do, but in some products and services we compete head to head with each of them. It does illustrate the variety available to consumers to satisfy their financial needs.

To illustrate this point, it is instructive to compare the choices available to a typical bank or securities brokerage customer ten years ago to those available today.

Before deregulation, a bank customer was limited in the choice of savings vehicles largely to a passbook account. Since interest rates were fixed, the customer could not shop different banks for a better rate because they all offered the same 5 1/4%. Of course, the customer could go to a savings institution and get one quarter of a point more. Because of inflation, these accounts paid a below market rate. Only those customers with $100,000 could obtain market rates by buying Treasuries or certificates of deposit. Checking account fees were relatively low, but balances did not earn interest, and obtaining cash from a checking account was sometimes difficult.

Today, by contrast, a customer can obtain a variety of savings accounts and shop banks for the best yield and most flexible terms. Competitive pressures from the securities industry's money market funds played a significant role in helping consumers gain access to market rates at their banks thus encouraging savings and enhancing capital formation. A customer also can get interest on checking balances and get cash and transfer funds between accounts at any hour, including weekends and

holidays. Furthermore, a customer can also obtain a variety of other services, such as discount brokerage and home equity loans, either separately or as part of a package.

A customer of a broker also had no opportunity to shop for better terms. Until May of 1975, commission rates were fixed and averaged one per cent of the principal. Investment opportunities generally were limited to the traditional stocks and bonds. And let's be fair, many brokers resisted "Mayday," and a number failed to survive the shift to negotiated rates.

Today's brokerage account, by contrast, offers varying commission rates and flexible services. It is not unusual for discount brokers to offer 20, 30, 50% and more off the pre-"Mayday" rate. Those who want a broader range of services can turn to the many full-service firms that offer professional research and advice. Investors can also obtain high yields through money market funds and liquid CDs, access their accounts by debit card or check and choose from a wide range of packaged investment products such as real estate, bond funds, mortgages and insurance.

Besides a wide range of choices, the consumer benefits from vast improvements in the speed and efficiency of transactions. The financial services industry has been in the forefront of the information revolution. The ATM, for example, has eliminated those long waits in the line to the bank teller's window.

Competition has another side, of course. The opportunity to succeed carries with it the risk of failure. The securities industry suffered through an upheaval following the elimination of fixed commission rates, and the thrift industry is still experiencing its own trauma. As painful as these experiences are for individual institutions, the result is a healthier, more efficient financial system. It is not simply a case of smaller firms being squeezed out by the giants in the industry. Many small institutions — thrifts, banks and securities firms — are flourishing because they are well managed, innovative and have chosen to play a specific role and to do it well. On the other hand, many very large firms have foundered, although I think you will find that the firms that have gotten into trouble have done so as a result of unwise expansion in their traditional lines of business, and not because of expansion into other fields. When interest rates and commissions were fixed, a profit could be turned without too much management creativity. This is no longer the case.

The most important point to remember is that the consumer has not suffered. The recent problems in Ohio and Maryland, for example, had nothing to do with deregulation. These largely resulted from a lack of confidence in the state insurance funds. Even the failure of federally insured banks and thrifts are not due to deregulation. They stem from imprudent loan or investment practices, uncontrolled growth, and mismanagement. Some attempt has been made by the Federal deposit insurance regulators to place the blame for bank and thrift failures on deposit brokers. As a firm which endeavors to verify the creditworthiness of banks and thrifts whose CDs we sell, we both resent the accusation and

regret the fact that it diverts attention from the true culprits: uncontrolled growth and inadequate supervision and enforcement. Merrill Lynch is well aware of the potential abuses brokered deposits pose for weak institutions, and we enthusiastically support efforts such as those contained in the legislation sponsored by your committee to curb those abuses while preserving legitimate deposit brokerage for sound institutions. We pledge our continued support for those legislative efforts. It is important to underscore the fact that selling CDs does not represent an expanded power for the broker. The fact that the customer's deposit is protected by federal insurance is a matter of right under the law. This is a right that your committee and the Senate has done its best to preserve, and we applaud your efforts.

In summary, I believe that the changes in the financial services industry have been the result of external forces that were probably irresistible. These changes have brought significant benefits to consumers through an unprecedented number of choices of new products and services. When these changes have run their course, the industry as a whole will be healthier and even more competitive.

2. The Future of the Industry

If what has happened so far is good, does it follow that total deregulation would be even better? There are some serious decisions to be made before that question can be answered with any confidence.

The first of these concerns economic concentration. Without the separation of banking and commerce, some see a risk of our falling into the German pattern where major banks control not only securities issuance and trading, but much of the country's industry as well. My own inclination is to believe that vigorous competition and enforcement of anti-trust laws will prevent such combinations from reaching the point where they have the ability to dominate our economic life. However we resolve the debate over the lines of demarcation between commercial banking and investment banking, it is difficult to conceive how the limited service bank owned by Merrill Lynch is a threat to the banking industry or the economy. Many commercial banks provide consumer oriented banking services. Others, like Bankers Trust in New York, have chosen to divest themselves of such activities, while still others, like Morgan Guaranty, never offered them in the first place. This is a classic example of institutions selecting their markets and concentrating resources on serving them efficiently. While such targeting is a common and useful business practice, it sometimes can leave a void in a particular market. Limited service banks fill such a void - another classic example of competitive forces at work. The beneficiaries are consumers, who have more choices and more service available to them.

One misconception in the current debate over so called "non-bank" banks is that they necessarily pave the way to interstate banking. Merrill Lynch has no position on regional or interstate banking, and no reason to wish to be a nationwide bank. If Congress decides that interstate banking

is not in the public interest, it can place such restrictions on limited service banks. There is no need to eliminate those entities altogether to protect against erosion of the McFadden Act.

Another question is the status of the regulators. We have always advocated functional regulation as the fairest and most efficient method of handling the situation where institutions expand into services outside their traditional role. Functional regulation would insure that some institutions do not gain competitive advantages by dealing with a friendly or less experienced regulator. Regulation of an activity should be the same for all who engage in it, regardless of how they do it or where.

Functional regulation is not enough, however, when there are legal or structural advantages that one type of institution has over another. For instance, banks engaged in the municipal securities business have tax and financing advantages over the securities dealers with whom they compete. Competition ought to be on equal terms for all who participate, and in many cases that should mean conducting different activities in different corporate entities. This again was a concept endorsed by this committee last year and which still remains a sound and efficient course of action. This concept should be reflected in any banking legislation considered this session.

Another weakness of our present system of regulatory diversity is the fact that it sometimes seems to foster competition among regulators rather than among institutions. In my opinion, the objectives of regulation should be:

First, to preserve the integrity of the marketplace. Regulation of the securities exchanges and regulation designed to insure the safety and soundness of the banking system are examples of this kind of regulation.

Second, regulation should protect the consumer against abuse. This kind of regulation includes disclosure requirements, protection against fraudulent practices and representations, and allowing the freest range of choice while providing protection from coercive tie-ins.

Third, regulation should insure the safety of customers' assets. This is done through deposit insurance and through net capital requirements and minimum standards for those engaging in the business.

Things that regulation should not do include protecting an institution or an industry against competition, or conversely, expanding the powers of an institution beyond those that Congress has intended. Regulation also should not attempt to protect institutions or individuals against themselves. The SEC has functioned pretty well as a protector of the investing public. Securities customers of the banks deserve no less.

Last is the question of Glass-Steagall separation between commercial and investment banking. This is related to the issue of economic concentration, but there are other considerations as well. The abuses and tie-ins between banks and their underwriting affiliates that led to the adoption of Glass-Steagall in the first place are well-documented. It can

be argued that the regulatory scheme that has grown up since that time is sufficient to prevent a recurrence of those abuses. That is obviously an inference that needs careful analysis.

Another way of putting the question might be, in view of the pressures for deregulation that I described earlier, is it desirable or inevitable that these barriers fall? I personally believe that financial services have evolved to the point where there are substantial benefits from combining many services in one organization. These benefits --convenience, efficiency, cost savings -- flow through to the customer. Because of the diversity of financial services, it is unlikely that any one institution could compete in all areas even if there were no regulatory barriers. Merrill Lynch, Sears, BankAmericorp and American Express are all engaged in financial services but they are very different institutions and likely to remain so. Nevertheless, regulatory barriers have led to differences among different types of institutions from the standpoint of taxation, access to and cost of capital, and regulatory emphasis. If the barriers were eliminated, or even if only some of them fall, then some institutions will have significant competitive advantages over others. The whole point of deregulation -- fostering competition --will have been frustrated.

It is clear then that the question of whether to do away with Glass-Steagall cannot be answered by a simple yes or no. The questions of economic concentration, abusive practices and, above all, a level competitive playing field, all need to be addressed first.

In summary, the evolution of the financial service industry has been the result of natural competitive forces brought on by inflationary pressures, technology and consumer demand. It has brought benefits to the economy and to the consumer, convenience, efficiency and innovation. Turning back the clock is simply not viable. Speeding up the process legislatively requires, in my judgment, a good deal more knowledge about the consequences than we currently possess. It also requires careful planning to ensure that some institutions do not obtain competitive advantages through legislation that they would not be able to obtain on their own merits. Safety and soundness and competitive equality should be the cornerstones of banking legislation. It makes little sense to increase the already abundant securities activities of banks when brokers remain threatened by removal of what few bank-like powers they do possess.

Our choice would be to permit the industry to evolve in response to competitive pressures. We may arrive at our destination more slowly, but once we are there we will be pretty confident that it is the best place to be. In the meantime, legislation should assure that regulation be streamlined in order to achieve the goal of regulation by function, reduce competitive favoritism and allow the marketplace to continue to shape the future.

The CHAIRMAN. Mr. Linton.

STATEMENT OF ROBERT E. LINTON, CHAIRMAN, DREXEL BURNHAM LAMBERT, INC.

Mr. LINTON. Mr. Chairman and members of the committee, I'm Robert E. Linton, chairman of Drexel Burnham Lambert, Inc. I'm currently halfway through my 40th year on Wall Street. I claim to have the longest tenure around at the moment. I last testified here almost 2 years ago on the 50th anniversary of the signing of Glass-Steagall, and agree with Mr. Robinson that most of what's to be said has been said.

So you'll be relieved to know that I have just struck the redundancies off my paper, which takes about 5 minutes out of what I was going to say.

The market for financial services has evolved rapidly and will no doubt continue to develop new products as creative minds continue to innovate. This is the way it should be since progress depends on people continuing to develop new ideas and improve upon old ones.

JUNK BONDS

I'd like to begin by discussing one innovation that Drexel is credited with developing—the public market for high-yield debt securities, often, and we believe pejoratively, referred to as junk bonds.

High-yield bonds derive their name from the above-market rates of interest they carry, due principally to the fact that they are rated below the first four ratings by Moody's and Standard & Poor's. The term junk bonds originally referred to debt securities which carried an investment-grade rating when issued, but which were subsequently downgraded when the issuer encountered financial difficulties.

Drexel recognized that these fallen angels often overcame their difficulties and had their ratings subsequently upgraded. In these situations, investors realized significant economic benefits. In order to capitalize on this advantage, Drexel developed analytical techniques to identify companies that are undervalued or that possess significant potential for growth. These techniques were subsequently used to identify companies that have excellent growth prospects, but which did not have the requisite track record of earnings or asset size to obtain an investment-grade rating.

Drexel has developed the market for these rising stars by underwriting new issues, placing them with investors, and maintaining a liquid market for those investors.

In 1984, we were the leading underwriter of high-yield bonds, underwriting 71 issues valued at about $9.7 billion. High-yield bond financing has provided direct access to the credit markets for a broad range of companies on very favorable and flexible terms.

The market for high-yield bonds has grown dramatically over the past 8 years. There are now over 2,000 issues outstanding in the market, with an aggregate market value between $75 and $100 billion. This includes all high-yield bond issues, including those that were originally issued with an investment-grade rating, but which were subsequently downgraded.

Approximately 350 companies have issued $35 billion in high-yield bonds over the past 8 years. About 14 billion dollars' worth of these bonds were issued last year. The daily dollar trading volume of high-yield bonds is quite large, ranging beyond $1 billion on active days.

The committee should recognize that of the approximately 20,000 companies in our country with assets in excess of $25 million, only about 675 qualify for a rating of investment grade. The high-yield bond market opens up the public debt markets to those companies that have demonstrated the ability to service their debt, but which are unable to secure a rating of investment grade because the rating agencies place considerable emphasis on the issuer's size and historic earnings performance record. The ability of these midsize companies to access the public credit markets directly provides them with the ability to raise capital for expansion and job creation. It is precisely these midsize companies that have been, and will continue to be, the source of most new jobs in our country.

A recent article in the May 27 edition of Business Week states that over 80 percent of the projected number of new jobs in 1985 will come from companies with fewer than 1,000 employees. Many of these companies are issuers of high-yield bonds—rapidly growing issuers such as MCI Communications, Ramada Inns, Charter Medical, Republic Airlines, Metromedia, People Express, and hundreds of others. Gains in employment in many of these companies that have issued high-yield bonds have been dramatic.

For example, employment at MCI has increased from 650 to over 10,000, and employees at Kinder-Care Learning Centers has increased from 900 to over 10,000 people in recent years.

The characteristics of high-yield bonds and the process by which they are issued are quite different than those of standard commercial loans. High-yield bonds are designed to provide the issuer with intermediate and long-term financing, an area in which banks generally do not provide financing. The bonds usually carry a term of 10 to 12 years, far in excess of the maturity of typical commercial bank credit. High-yield bonds usually carry a fixed rate to maturity. This provides the issuer with certainty concerning its cost of funds over the period the bonds are outstanding.

Commercial bank loans, on the other hand, typically provide for a floating rate tied to the bank's prime rate, since most of the bank's funds are raised in short-term markets at floating rates.

LIQUIDITY OF HIGH-YIELD BONDS

It's also important to point out that high-yield bonds are highly liquid instruments which can be resold quickly in the secondary market. This provides an added degree of flexibility and protection to purchasers. Drexel provides liquidity for the secondary market by acting as a dealer in high-yield bonds. In fact, our trading inventory of high-yield bonds exceeds $1 billion a day, and sometimes exceeds that substantially. Commercial loans, on the other hand, are highly illiquid.

Finally, and most importantly, the process involved in issuing a high-yield bond and extending a commercial loan are dramatically different. A high-yield bond involves a public offering of a security

underwritten by an investment banker who is placing the capital of the institution at risk if the underwriting is unsuccessful. In addition, the underwriter conducts a thorough due diligence review before the transaction is consummated. The transaction takes place in the private capital markets and involves exclusively the funds of private parties. It is the private parties involved in the transaction that bear the risk. Banks employ funds that are backed by Federal deposit insurance. Consequently, if the bank is unsuccessful, it is the Federal Government and the taxpayers that ultimately bear the loss.

One of the justifications given to allow commercial banks into security underwriting is to improve their financial security by providing new sources of profits.

I believe Secretary Baker was the latest to espouse such action before this committee last week. Remember, however, that reward is commensurate with risk. Underwriting investment-grade securities is already highly competitive and carries spreads so narrow as to preclude much profit.

The firms in our industry which make substantial profits are those that take substantial risks—hardly a course of action advisable for institutions which are supposed to assure the return of their depositors' funds.

I firmly believe the banks are unique institutions. When banks get in financial trouble, the regulators will go to great extremes to resolve the matter, as we have witnessed in connection with the bailout of Continental Illinois Bank. Unfortunately, we, as investment bankers, do not enjoy such advantages. I would particularly point to the fact not often enough raised that the banks do not have to mark their portfolios to the market. They can carry, as they do today, 6 percent loans in a 9-percent loan market at par.

In our business, we have to mark ourselves to the market day-by-day and if our inventory goes down, we must provide the capital and the security to the public clients in order to carry those securities at their real present value.

Mr. Chairman, your committee is well aware of the problems of the Nation's financial industry and the abuses that have taken place in recent years. As a result, our banking system is more fragile than ever. The Federal insurance funds and the resources of the Federal supervisors are being strained to their limits in dealing with the problems of our banks and thrifts.

In view of these problems, I seriously question whether Congress should break down the barriers between banking and the securities industry. It is of overriding public importance to preserve the role of our country's depository institutions as impartial providers of credit and to reduce the likelihood that they will engage in speculative activities.

As I've stated on several occasions before this and other committees of Congress, a better, more logical approach is for Congress now to enact legislation that closes the loopholes that have eroded the barriers between our industries and to begin developing a comprehensive legislative program that places banks and thrifts on a safe and sound financial footing, while preserving the public's confidence in our financial system. Thank you.

[The complete prepared statement follows:]

STATEMENT OF

ROBERT E. LINTON

CHAIRMAN

DREXEL BURNHAM LAMBERT INCORPORATED

Mr. Chairman and Members of the Committee:

I am Robert E. Linton, Chairman of Drexel Burnham Lambert Incorporated. I am currently in my fortieth year on Wall Street, all with one firm. Drexel is the country's second largest privately owned investment firm. Last year, our total corporate underwritings exceeded $10.8 billion. I appreciate the opportunity to present my views as to the appropriate legislative response to our rapidly evolving financial services industry and in particular to discuss Drexel's role in the high yield bond market.

Mr. Chairman, you and the Members of your Committee have embarked upon the critically important mission of determining the role depository institutions will play in the decades to come through a consideration of the products and services they may offer. It is vital to the continued economic strength of this country that our nation's banks and thrift institutions be safe and sound repositories of the public's funds. For if public confidence in these institutions is not preserved, it will be virtually impossible for us to continue to make economic progress in the future.

As many witnesses who have preceded me over the past few years have attested to before this Committee,

the market for financial services has evolved rapidly and will no doubt continue to develop new products as creative minds continue to innovate. And this is the way it should be, since progress depends upon people continuing to develop new ideas and improving upon the old ones.

I would like to begin by discussing one innovation that Drexel is credited with developing -- the public market for high yield debt securities, often (and we believe pejoratively) referred to as "junk bonds." High yield bonds derive their name from the above market rates of interest they carry, due principally to the fact that they are rated below the first four ratings by Moody's and Standard & Poor's. The term "junk bonds" originally referred to debt securities which carried an investment grade rating when issued, but which were subsequently downgraded when the issuer encountered financial difficulties. As a result, the financial community applied the term "junk bonds" to these investments in recognition of the problems faced by their issuers.

Drexel recognized that these "fallen angels" often overcame their difficulties and had their ratings subsequently upgraded. In these situations, investors realized significant economic benefits. In order to capitalize on this advantage, Drexel developed analytical

techniques to identify companies that are undervalued or that possess significant potential for growth. These techniques were subsequently used to identify companies that have excellent growth prospects but which did not have the requisite track record of earnings or asset size to obtain an investment grade rating from the agencies. Drexel has developed the market for these "rising stars" by underwriting new issues, placing them with investors and maintaining a liquid market for those investors. In 1984, we were the leading underwriter of high yield bonds, underwriting 71 issues valued at about $9.7 billion. High yield bond financing has provided direct access to the credit markets to a broad range of companies on very favorable and flexible terms.

The market for high yield bonds has grown dramatically over the past eight years. There are now over 2,000 issues outstanding in the market, with an aggregate market value of between $75 to $100 billion. This includes all high yield bond issues, including those that were originally issued with an investment grade rating but which were subsequently downgraded.

Approximately, 350 companies have issued $35 billion in high yield bonds over the past eight

years. About $14 billion worth of these bonds were issued last year. The daily dollar trading volume of high yield bonds is quite large, ranging beyond a billion dollars on active days.

The Committee should recognize that of the approximately 20,000 companies in our country with assets in excess of $25 million only about 675 qualify for a rating of investment grade. The high yield bond market opens up the public debt markets to those companies that have demonstrated the ability to service their debt but which are unable to secure a rating of investment grade because the rating agencies place considerable emphasis upon the issuer's size and historic earnings performance record. The ability of these mid-sized companies to access the public credit markets directly provides them with the ability to raise capital for expansion and job creation.

It is precisely these mid-sized companies that have been and will continue to be the source of most new jobs in our country. A recent article in the May 27th edition of Business Week states that over 80% of the projected number of new jobs in 1985 will come from companies with fewer than 1,000 employees. Many of these companies are issuers of high yield bonds. Other rapidly

growing issuers of high yield bonds are such firms as MCI Communications, Ramada Inns, Charter Medical, Republic Airlines, Metromedia, and People Express. Gains in employment in many of the companies that have issued high yield bonds has been dramatic. For example, employment at MCI has increased from 650 to over 10,000 and employment at Kinder-Care Learning Centers, has increased from 900 to over 10,000 people in recent years.

The process by which high yield bonds are issued and many of their characteristics are quite different than those of standard commercial loans. High yield bonds are designed to provide the issuer with intermediate and long-term financing, an area in which banks generally do not provide financing. The bonds usually carry a term of 10 to 12 years, far in excess of the maturity of typical commercial bank credit. High yield bonds usually carry a fixed rate to maturity. This provides the issuer with certainty concerning its cost of funds over the period the bonds are outstanding. Commercial bank loans on the other hand typically provide for a floating rate tied to the bank's prime rate since most of the bank's funds are raised in short-term markets at floating rates. The borrower, therefore, is uncertain as to what its funding cost will be and assumes a substan-

tial risk that it will vary dramatically over the term of the loan. Bank loans often require the borrower to provide security and to agree to highly restrictive financial and operating conditions. High yield bonds provide issuers with flexibility to operate without overly burdensome restrictions.

It is also important to point out that high yield bonds are highly liquid instruments, which can be resold quickly in the secondary market. This provides an added degree of flexibility and protection to purchasers. Drexel provides liquidity for the secondary market by acting as a dealer in high yield bonds. In fact, our trading inventory of high yield bonds approximates $1 billion each day. Commercial loans, on the other hand, are highly illiquid. Once a bank makes the loan, it is unlikely that it can be sold easily in the secondary market.

One of the justifications given to allow commercial banks into security underwriting is to improve their financial stability by providing new sources of profit. I believe Secretary Baker was the latest to espouse such action before this Committee last week. Remember, however, that rewards are commensurate with risk. Underwriting investment grade securities is al-

ready highly competitive and carries spreads so narrow as to preclude much profit. The firms in our industry which make substantial profits are those that take substantial risks. Hardly a course of action advisable for institutions which are supposed to assure the return of their depositors' funds.

Finally, and most importantly, the process involved in issuing a high yield bond and extending a commercial loan are dramatically different. A high yield bond involves a public offering of a security underwritting by an investment banker, who is placing the capital of the institution at risk if the underwriting is unsuccessful. In addition, the underwriter conducts a thorough due diligence review before the transaction is consummated. The transaction takes place in the private capital markets and involves exclusively the funds of private parties. It is the private parties involved in the transaction that bear the risk. Commercial loans, of course, do not involve public offerings, and therefore do not undergo the extra reviews by other parties that are a normal part of the underwriting process. In addition, banks employ funds that are backed by Federal deposit insurance. Consequently, if the bank is unsuccessful, it

is the Federal government and the taxpayer that ultimately bear the loss.

I firmly believe that banks are unique institutions, despite the many changes that have occurred in recent years. They are able to raise funds from depositors who are protected by Federal deposit insurance; when banks face a liquidity squeeze they can borrow from the Federal Reserve's discount window; banks possess unique tax advantages and they run the nation's payments mechanism; and banks are the mechanism through which the Federal Reserve's monetary policy actions are transmitted to the rest of the financial system. When banks get in financial trouble, the regulators will go to great extremes to resolve the matter, as we have witnessed in connection with the bailout of Continental Illinois Bank. Unfortunately, we as investment bankers do not enjoy any of these advantages.

Preserving public confidence in our nation's banks is vital to maintaining stability in our economy. As events in Maryland and Ohio have demonstrated, public confidence in our financial institutions is quite fragile, and once shaken is difficult, if not impossible, to restore.

As a result of abuses in the 1920's and 1930's by commercial banks that were engaged in securities activities, public confidence in banks was lost. In order to restore the public's faith, Congress enacted comprehensive banking reforms, including the Glass-Steagall Act, Federal deposit insurance, and additional supervisory tools. I believe the reasons for the protections that Congress so wisely constructed in 1933 that separated banking and securities activities remain even more valid in today's highly competitive financial services market than when they were originally enacted.

Congress enacted the Glass-Steagall Act because it was concerned that banks engaging in securities activities would no longer be impartial providers of credit, and that they would face unavoidable conflicts of interest. In addition, Congress was also concerned about the inherent risks involved in the securities business as well as the unfair competition that results when a bank that extends credit also deals in securities.

Mr. Chairman, your Committee is well aware of the problems of the nation's financial industry and the abuses that have taken place in recent years. As a result, our banking system is more fragile than ever. The Federal insurance funds and the resources of the Federal

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supervisors, are being strained to their limits in dealing with the problems of our banks and thrifts. In view of these problems, I seriously question whether Congress should break down the barriers between banking and the securities business.

It is of overriding public importance to preserve the role of our country's depository institutions as impartial providers of credit and to reduce the likelihood that they will engage in speculative activities. As I have stated on several occasions before this and other Committees of Congress, a better, more logical approach is for Congress now to enact legislation that closes the loopholes that have eroded the barriers between our industries and to begin developing a comprehensive legislative program that places banks and thrifts on a safe and sound financial footing while preserving the public's confidence in our financial system. While you have been studying this matter for some time now, I do not believe that you have yet achieved a solution that satisfies these objectives, and I believe events of recent months concerning losses incurred by depository institutions involved in the repurchase agreement and real estate development market confirm this conclusion.

The CHAIRMAN. Thank you, Mr. Linton.

As Mr. Robinson said, there's nothing very new or different. I certainly agree with that. That's why we had these additional hearings. After so many years of facing each other across this table, it's very fundamental. Simply that, although the substance of the testimony may not be necessary any more, it is necessary to give people the opportunity to be heard.

I'm sorry we had this series of hearings at all. I wish the House had passed the bill last year after we passed one 89 to 5 in the Senate. We'd taken that additional step, and then this year would have been devoted to looking at reform of the regulatory structure for financial institutions, trying to go to regulation by function, looking at risk-related premiums and a revision of the deposit insurance system of this country.

That's where we should have been, and that's where I would have preferred to be.

OPPORTUNITY FOR ALL TO BE HEARD

But, on the other hand, as long as I am chairman of this committee, everybody will be given the opportunity to express their point of view, regardless of how long it takes and how many hearings, so that nobody afterwards, when we produce legislation, can say that was done secretly, I didn't know about it, I didn't have my opportunity to express by viewpoint.

So while there's some redundancy, which I regret, if we don't pass a comprehensive bill this year, we'll hold more testimony and we'll invite you back next year until somebody in Congress decides that they are willing to go ahead and try and set some policy and try and shape the financial services industry, rather than going to just loophole closers.

I suppose I don't disagree a great deal with your testimony. Mr. Robinson, you certainly have outlined three points that I don't disagree with. I never disagree at all with the testimony of witnesses on the importance of safety and soundness. Your first point of a safe and sound banking system should be assured. It's motherhood and apple pie. We all agree with that.

It would be very nice if we could pigeonhole depository institutions and say, hey, banks, do what you've always done. Stick with Glass-Steagall. Don't do anything else. Try and perfect and do more safely what you've already been doing, and that would be fine.

But the element that none of you brings out is the different structure of your activities.

American Express is not the same business, Jim, that it was 5 years ago, or 10 years ago. I talked to the insurance people yesterday. I used to be an insurance person. I'm not qualified to be in it any more. It bears no relationship to the business I worked in 15 years ago.

And Merrill Lynch, who would have ever thought of cash management accounts and dealing with bank one and all of the activities that you're in today? It's a different ball game.

It's true of Drexel, too. It's not the same when you started in the securities business. The securities business isn't the same at all.

So what you're telling me I agree with in principle—let's keep the banking system safe and sound. But what you're saying is keep them the way they've always been. Not all of you are saying exactly that. But that is the general thrust of testimony of those who oppose any changes for banks, or credit unions, or thrifts in this country.

Let us evolve with changing market conditions, but keep them exactly where they are, and always raise the flag of safety and soundness because, boy, that's good and that strikes a responsive chord and you can't do anything to endanger them. That strikes a responsive chord with many of my colleagues here, and it should. That No. 1 point you make is exactly true.

But I don't know how to do that. I just don't know how to do that, other than to try in a very measured, slow way to give the depository institutions an opportunity to compete, or take away the things that people are doing that are banklike services. And I don't want to do that, either. I don't think that's responsible. I don't want to tell any of you that we'll move your businesses back 10 years, take away things that you have found are of benefit to the consumer because the consumer has benefited from this financial services revolution. I don't think there's any doubt about that.

So I don't know. It's a dilemma that I only know one way to go—try and walk through that minefield of expanding banking powers to sufficiently allow them to compete without penalizing the innovation in your businesses and telling you that you've got to stay fixed. You can't move. You can't develop new products.

As you know, I've told both of your predecessors, Don Regan and Roger Birk, that I have no complaint about the invention of money market accounts and cash management accounts or even the $200 billion of outflow from depository institutions into those types of instruments.

It isn't my political philosophy to say, if we can serve the customers better, do it. But boy, what an advantage you had for a while, to pay 14 or 15 percent while we sat here and told depository institutions, for safety and soundness, you can pay 5¼ and 5½ percent.

That's a pretty good deal when you've got the Government to cut off your competition like that for a while.

Well, we've resolved that one and people can make their choices between a bank account and CMA's and so on.

That's what I'm trying to do, gentlemen, and it's not an easy task and there are a lot of differences of opinion. But with technology changing so rapidly, we can't lock one part of the financial services industry into a static condition and then say, let's keep them safe and sound, because if we hadn't freed up those interest rates when we moved regulation Q, I don't know whether we'd have an FSLIC in 1985 or whether we'd have a thrifts industry at all.

Mr. Linton, you wish to comment.

Mr. LINTON. Well, Mr. Chairman, it would take a bit of research, but I think if you went back 25 years and made a chart of activities of Merrill Lynch in those two periods and Citicorp in those two periods, in my feel for the matter, you'd find more change at Citicorp than you would in our industry.

They've got a roomful of——

The CHAIRMAN. It depends on whose charts you look at. Walt Wriston testified before this committee a couple of years ago and he had a chart that had a list about this long for Citicorp [indicating] and about this long [indicating] for the other side.

So whoever's chart you want to look at.

Mr. LINTON. I mean, they're wheeling and dealing and swaps and repos. They're got a private placement department that dwarfs those of most investment bankers. If one really were to look at them, it's a far cry from the traditions of the banking business as we know it, which I agree is true in our industry also.

The CHAIRMAN. I don't necessarily disagree with you. But what you've got to remember is my job here is not to take care of Citicorp, Chase, and Bank America. My primary interest representing a small State is 14,000 banks—I don't have a big bank in my State. Even our mutual friend that runs First Security—that isn't a big bank nationally. It's a big one in Utah. And most of those people, most of the banks of this country are still relatively small, very small. Most of thrifts are and most of the credit unions are. And they're not in that list of activities that Walt got into. That's the difference.

BIASED TOWARD THE LITTLE GUYS

Maybe when you come from New York, you look in terms of the great big biggies. Well, I'm not from New York and I had to deal when I was mayor of Salt Lake City with the mayor of New York. So I have to admit, I have a bias toward more competition among the little guys. All of you big guys will take care of yourselves rather adequately. You don't need help from Jake Garn or this committee. You'll survive.

So when I'm looking at some of these smaller institutions surviving, it might really help in Salt Lake City if they could compete in municipal revenue bonds. And I know as a mayor, I would have gotten lower bids for my bonds when I had to float them if I had some more competition in that city, without regard to Walt Wriston, or Citicorp, and all the biggies that play games with each other in New York.

Jim.

Mr. ROBINSON. Mr. Chairman, I would like to comment on the observation of hiding behind safety and soundness.

There's nothing in our position ever that has said, don't grant banks added powers. We don't look to any form of regulation to give us a captive hunting ground. If such conditions existed, we would assume it wouldn't exist for very long.

We are simply saying that if you're going to start giving added powers—and the problem, I think, with last year's bill is that it gave a lot more power to the banks than it provided to other institutions—in ad hoc fashion to one industry and then to another, Congress will be creating temporary competitive advantages at the expense of the Market as a whole.

So from our perspective, go to separate subsidiary—functional regulation—you've already got the infrastructure for dealing with Government securities in those separate areas, and give yourself

the opportunity to have the cross-competitiveness that you're seeking.

The other comment on money market funds—they never should have existed. They wouldn't have happened if the banks had been able to offer market rates to the consumer.

The CHAIRMAN. I agree.

Mr. ROBINSON. So, again, it was not looking for a captive private preserve. It was simply an entrepreneur figuring out a way to serve that marketplace. And that $200 billion plus didn't leave the system. It simply got recycled.

The CHAIRMAN. No; I agree with you. I made that comment many times, and I did today. I don't criticize for filling that gap. It was a criticism of regulation Q, which was supposed to be a temporary measure and should have been removed many, many years ago. The thrift industry would not have gotten in the really bad trouble they did if that had been phased out long ago, and they could have been competitive rather than trying to devise sweep accounts to compete and the repos, and all of the things that they were dealing with to try to attract funds.

So I don't disagree with that comment at all.

Just one more. You said a lot more toward the banks last year than others. I would expect you're aware that the only two new powers in that bill were mortgage-backed securities and municipal revenue bonds.

Is that a lot more?

Mr. ROBINSON. Relative to what the others got.

The CHAIRMAN. Well, relative to what you may already have.

Mr. ROBINSON. Yes.

Mr. SCHREYER. Mr. Chairman, I listened carefully to what you said and I think—first of all, I think Jim Robinson's, or American Express' position, and ours is very close. Maybe identical. And I agreed with virtually everything you said in terms of the opportunities we have had and enjoy and all the things that have happened.

I think that we were not, again, opposed to—we took advantage of an opportunity and, as you say, that regulation Q correction took care of that.

And then we also pointed out that you're not concerned about the Citicorps. But I think in this particular bill that hopefully will some day be resolved, the Citicorps are there and the Bank of Americas are there.

So, all we're saying—for example, coming over this morning, I couldn't help but pick up the paper and on the back, it says, "Citicorp—the leader in swaps." "Citicorp Investment Bank." And then the back page of the Wall Street Journal, "What bank brings a spirit of merchant banking to the securities, operating and information services? Bankers Trust."

PURPOSE IS TO FOSTER COMPETITION

Now we're not opposed to these additional powers being given to the banks, large and small. All we ask for is that the purpose of deregulation is supposed to foster competition, which will end up helping the financial consumer and the whole system.

If we have equal regulation, equal taxation, equal everything—and I know that word level playing field, I'm sick of it. I'm sure you're more sick of it than I am. And this world that we're living in will never be that perfect. But if we can get it closer, it will certainly be a giant step forward.

So we're willing to compete with anybody. We think deregulation, increased competition—you mentioned municipals earlier—the banks, in their municipal portfolios, in addition to not having the market, but they are allowed, for example, to deduct the interest that they use to carry their portfolio of municipal bonds and we are not.

This is just a series of things like this that does not make it fair or equal competition. They have a lower tax rate, et cetera, et cetera, et cetera. Which is the only reason—we talk about this. We say, well, let's stop the nonbank bank of New Jersey or let's stop this loophole there. I think that's a step back instead of a step forward. I think we ought to let competition, deregulation evolve, but I believe the way to do it is a comprehensive review of the whole—you've got all the testimony and I support Jim's recommendation of a comprehensive use, so the final result is this fair and equal competition that we've been talking about.

The CHAIRMAN. Well, I don't disagree and that's why I made the comment, I wish we had proceeded to the other areas of attempting to achieve some fairness.

Mr. SCHREYER. Yes.

The CHAIRMAN. Reform the depository insurance system and regulation.

I think all of you know how strongly I am in favor of regulation by function. Regardless of what we do with powers, and regardless of what kind of institution they call themselves, they are regulated in the same manner, and you still have unfairness.

Senator Riegle.

Senator RIEGLE. Thank you. These small additions of powers that the chairman was referring to are like salami slices. If you read the testimony of Don Regan, when he appeared here as Treasury Secretary, or Jim Baker, they see these additional powers as a progression in a direction toward an entirely different final outcome. And it raises very serious questions. It seems to me that one can almost ask, if the banks are going to move into the securities business and investment banking fully and retain Federal deposit insurance, that maybe you folks ought to have Federal deposit insurance for that part of your business.

It seems to me that the whole question of the equities involved is a very real question.

I agree with the notion that we ought to try to size this problem up by stepping back from it and looking at it in an overall way, which is what you described in your testimony, Mr. Robinson.

So let me pose the question, my first question, this way. I'm interested in the question of how strong the structure is right now and whether we're stretching it out in different ways, maybe beyond prudent limits. And if so, what that means. If that is so, then the issue of major deregulation or reregulation may take on a different meaning.

In previous testimony before this committee, we've heard that the number of problem banks is presently at an all-time high of 949, and that bank failures this year will almost certainly exceed last year's postdepression record of 79. And the number of problem savings and loan institutions is also increasing.

We've recently had runs on State-chartered S&L's and failures of Government securities dealers. I'm also picking up signals that certain parts of the insurance business are under considerable financial stress as well.

Now we're reading stories about the problems both in Argentina and Mexico with oil prices dropping—all of which amounts to an addition of stress to our financial system rather than a subtraction from it.

I'd like to hear from each of you, what do you think are the underlying causes of some of this instability in the financial services industry as described by these statistics and what specific changes, if any, do you think we ought to be making with respect to dealing with that set of realities?

Mr. ROBINSON. Well, let me start by saying I think that the capital markets, the money markets in this country, the whole infrastructure, is one of our greatest national assets, despite its warts. It's generating capital for this country and for the entire world. And it's doing that because it's got an incredible capacity to intermediate and to recycle. And that, perhaps, is our greatest strength. Also, mortgage-backed securities, which allowed the thrift industry to take care of some of its liquidity problems, is an example of how that process happens.

The packaging, with the use of technology and the computer to track all of the payments on mortgages, creates an entirely new market for that paper.

So that process can go on.

THE SYSTEM IS FRAGILE

I do think that the system is fragile. The very fact that a problem in the State of Ohio related to State-chartered thrifts could cause a temporary phenomenon in the international marketplace as it did is an indication of the degree of fragileness. The market, of course, self-corrected.

It seems to me that what this says is that step 1 in your process should be the functional regulation. You have the regulatory authorities now to deal with the thrifts, with the banks, and with the securities industry respectively, let them do it.

To the extent that you try to piecemeal and modify in the salami-slicing fashion the existing regulations to ease one area into another, et cetera, you run into the problem of distortions, to wit, under Garn-St Germain, nonthrift and noncommercial bank industry capital allowed to come into the thrift industry unfortunately, the Federal Home Loan Bank won't process those applications. We have been on file for some time as being interested. That keeps capital out of the institution structure.

To me, that doesn't make sense.

I call this the age of the frisky regulator. And that's good. In the insurance industry—they're beginning to look at the accounting

procedures and to look at the capital ratios and they are tightening up. The rating agencies are doing likewise. The same thing is true in the banking industry. The rating agencies are doing likewise. That is causing a self-correction mechanism.

Directors liability insurance is harder to obtain—at least not without a substantial increase in cost. There's nothing that sobers up a director like recognizing that he has individual risks in a situation in terms of paying attention to what an institution is doing.

The role of the audit committee of those institutions is awakened by this kind of phenomenon.

So I wouldn't try to legislatively tinker with the system. Instead, set it so that the regulators can regulate within the areas regardless of the form of the institution as step 1. And step 2, given that you're using the momentum of the infrastructure, step back and look at the public policy objectives that you want to achieve and accomplish and then, determine what modifications in Glass-Steagall, what modifications in banking holding companies, or in the other laws should take place.

Mr. ROBINSON. Mr. Linton or Mr. Schreyer? Go ahead.

Mr. LINTON. I'd say three things. No. 1, I support a direction that I think you're going and that is to increase the net capital requirements of those banking institutions. It's been suggested, for example, that the S&L's go from 3 to 6 percent. We would support that completely.

No. 2, those net capital requirements are meaningless unless you mark the portfolios to the market. Many of these institutions, if liquidated, are under water. And so there has to be a gradual phase in—you couldn't do it all at one time. It would ruin the system—you've got to wean the system to the market structure, as our industry is, and that is what has saved our industry in difficult times.

Senator RIEGLE. You know, if I may just say on that before you go to your next two, the nine biggest banks in the country have over 100 percent of their net worth in outstanding loans to four countries—Argentina, Mexico, Brazil, and Venezuela.

And so, I'm not sure how we would decide what the market value might be on those loans because they don't look to me to be investment grade as I would think of it. But we've got problems even doing that, it seems to me.

But why don't you continue?

Mr. LINTON. It's not easy in our industry also to put a value on nonmarketable instruments. And, therefore, our haircuts, if I may use that word, are greater as the obligations become less marketable.

So if a bank has a portfolio of marketable securities, they would have, as we would have, less of a haircut than a loan to Argentina.

So I think a formula can be developed. My last point is, and we've all said this—don't allow the banks to increase their risks.

Now when I hear that the Senate has passed a bill rather blithely allowing the banks into the underwriting of mortgage-backed securities, with all due respect, I'm not sure that you have investigated the risks in underwriting mortgage-backed securities. It is a damn risky business. In the whole loan end of it, which is by far the most profitable end of the business, you have to buy hundreds

of millions of dollars of mortgages as a principal and you must own that portfolio for 1, 2, 3, 5, 6 weeks while you are breaking it into its components, arranging buyers, and doing the distribution.

So you sit there naked with a $500 million portfolio of mortgage-backed securities while you're doing that transaction.

HAS THE BROADEST PROFIT MARGIN

The flip side is that this type of business has the broadest profit margin. The percentage of spread is the greatest. That's where the profits are. That's where the risks are.

For God's sake, don't let the banks into the underwriting of mortgage-backed securities. It's going to be one more nail in the coffin of the system.

Mr. SCHREYER. I'm just trying to think what I might add to what has already been said.

I think both of them, and Jim certainly, covered all the points. The only thing I might add is that you look back to the securities industry in 1975, going from fixed commissions to competitive, and that caused a great uproar, a great unsettlement in our industry. Some very large firms didn't make it, and yet, some very small firms did extremely well. It didn't take, in all due respect to our forefathers, it didn't take an incredible amount of management talent to be successful back during the days of fixed commissions and no competition, really.

Then, when it deregulated and when competition became intense and pricing competition, new services, new products, that's when the management challenges really began.

So, in addition to regulation and regulators regulating and supervisors supervising, the ultimate thing boils down to people and it boils down to the management capability of a particular institution. If they manage well, if they don't go into the banking industry for explosive growth and just lay it on loans that they shouldn't, et cetera, et cetera, that, of course, is the third thing—the legislation, regulation, and management.

Senator RIEGLE. Mr. Robinson, in an article which you had published in the May 16 edition of the New York Times, entitled, "Superdollars and Superdebt," you talked about what's happening internationally, and the trade deficit and you pointed out that we were about to become a debtor nation. And the trend lines are not encouraging.

You spoke about that, I thought, very forcefully in your piece, and I think very constructively.

Now, when the banks come in to talk about new powers, they see the expanded list of activities as being the way to get well in a hurry.

Given the outstanding loans to the lesser developed countries and the debt of some of these countries, and the involvement of some our financial institutions with these countries—when the banks make the assertion that they've got to get into new lines of business, what is your response?

Mr. ROBINSON. Well, the grass always looks greener, I suppose. Who got the banks in that position in the first place? We didn't. Of

course, we have a subsidiary with its share of loans to the developing world.

I think that the confidence in the system and the recycling capacity and innovation, as long as we can keep the world going as it is now, has the capacity to work out from there. The austerity programs that are put in place sooner or later are going to have to offer some economic opportunity or those countries are going to get tired of servicing debt to foreign banks who are faceless institutions.

That's a separate matter entirely because the number of banks who are involved in that kind of situation are small relative to the 14,000 or so that Chairman Garn spoke of.

I don't see new and additional powers as the golden fleece or opportunity to get banks out from the hole that they're in. We don't oppose banks being able to go into other forms of business provided they're regulated as others in those businesses are regulated, so that we are all playing by the same rules.

Mr. LINTON. Senator Riegle, I'd like to answer part of that and unfortunately take a bit of an exception to Mr. Robinson's testimony.

MATTER OF SEPARATE SUBSIDIARIES

I don't believe that separate subsidiaries for banks is the answer at all, or that one can say, OK, let the subsidiary go broke. We'll put all these risky activities in there and it won't affect the banks.

That is just not the real world. I remember so well a situation not even as close as a separate subsidiary—in the days of the REIT's, we could not convince our customers that the Chase REIT had nothing to do with the Chase Bank. They were buying those securities even after it got in trouble, with the idea, well, the Chase will never let this go under.

Well, that isn't necessarily the case. You can't make a generality either way that a bank could let a subsidiary go broke or that a bank would have to stand there and protect a subsidiary.

I think it's very dangerous to look at it that way. We have the same thing in our business. We must have 50 separately incorporated subsidiaries and we absolutely know that anything that has the word Drexel Burnham Lambert on it, we must protect and must stand behind, irrespective of the legalities.

Mr. ROBINSON. That's true. I would think that the individual regulators who supervise those functions, if they're concerned about the extent to which a subsidiary or a bank has gone beyond what would be deemed prudent—and the marketplace tells you because the marketplace values the certificates of deposit, the floating rate notes, and so forth, of these institutions—have the authority to intervene.

So that the Fed right now has the capacity to set guidelines for capital to deposit ratios, et cetera. The insurance commissioners in the respective States have the guildelines to set the ratios. And I think more and more, that's being done. That, in our view, would be the way to deal with the individual regulation and prudence of any activities.

Certainly, we would subscribe to the fact that if they've got your name on it you're going to have to fix it.

Senator RIEGLE. My time has expired, Mr. Chairman.

The CHAIRMAN. Before I turn to Senator Hecht, I'd just comment and thank you, Mr. Robinson, for bringing us back to a point that I've been trying to make for a long time in these hearings, that the discussion comes back again when we get to safety and soundness in talking about the big boys. And foreign loans is some great specter out there in safety and soundness.

Thank you for mentioning 14,000 banks because, as chairman of this committee, I'm trying to deal not with just the big boys, but small securities people and small bankers and so on, the system.

We so often evolve into talking about the big ones and so on. The vast majority of the banks in this country have never made a foreign loan. They are not in the kind of difficulty that some of those are. That's part of the system.

The day that I start addressing legislation to 9 or 10 banks or 9 or 10 securities firms and saying, that is the way, then I don't deserve to be chairman of this committee any more.

Well, thank you for mentioning in the testimony that there are 14,000 banks out there and not just look at this part of it and use that as a boogeyman for why we should not look at an entire system.

Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman.

Mr. Schreyer, you mentioned in your testimony that you didn't like the Senate-passed version of the banking bill last year and you don't like the House version that's passed this year.

That puts you in a rough spot. What do you suggest in the middle? [Laughter.]

Mr. SCHREYER. No, it puts me out in left field, I think.

What I talked about not liking was the date—we've spent a tremendous amount of time and effort getting our nonbank bank set up in Jersey, and under both the Senate bill last year and the recently House-passed bill, where it's effectively put us, it wouldn't let us be qualified to continue on that, having a nonbank bank.

I tried to point out in my testimony why I thought we should have that particular service to continue the efficiency of our own operations.

Senator HECHT. Let me get that exactly, then. Basically, you're not trying to close the loopholes. You're against the grandfathering, the date of the grandfathering clause.

Is that correct?

Mr. SCHREYER. I'm merely saying that the Senate bill last year would have prohibited us from going ahead with our banks. It was the date in the Senate bill, certainly.

Senator HECHT. That's correct.

Mr. SCHREYER. Not the balance of it.

Senator HECHT. Mr. Linton—excuse me. I'll get right back—you kind of took exception. You thought that we should close loopholes immediately.

SENSIBLE LOOPHOLE-CLOSING BILL

Mr. LINTON. Yes. I think that a sensible loophole-closing bill should be passed as soon as possible. I think the encroachment across lines from one industry to another should be halted. I wouldn't try to be smart enough to pick what date to go to, but I would put a grandfather date on and I would stop it at a certain point.

I think that your chairman has a very good point as far as competition between these industries and I would try to stop it.

Senator HECHT. Both you gentlemen are in the securities business, so you do not have——

Mr. SCHREYER. No, you're quite right. We have different viewpoints, as I'm sure the various members of the banking world have different viewpoints. Citicorps, I'm sure have a different view than the bank from Salt Lake City.

So we don't agree entirely. We certainly believe in certain basics such as safety and all that sort of thing, proper regulation.

But I think that the business of simply closing loopholes when the things have already happened, the banks are in our industry, in our business, and I think going the salami approach isn't the answer, which is why I recommended that a fully comprehensive review be made and all done at once, which the Senator said he hoped to be in that position by now.

So, I think we start with the odd lots, if you will—they're not really odd lots—is not the answer. So I go back to the premise that, hey, stop the world. Let's take a breath. Let's look at the whole thing and let's have—if we believe that deregulation brings about better service, better quality products, better everything for the financial consumer, then let us compete on equal terms, equal taxation, equal regulation, by function.

I do believe that the financial system is strong enough to be able to adapt to this if it's done in a comprehensive way.

And I think another thing that hasn't been said, at least not today, is that, whether we like it or not, the world and financial markets are truly becoming global markets and that pretty soon we'll be trading stocks between New York and Tokyo and London like we do just in New York today.

So I think that the outlook requires a strong financial system, which means strong financial firms, institutions who are able to compete on a global basis. I think with that kind of a comprehensive overhaul, strong regulations, strong supervision, and the ones who are going to fail are going to be the weakly managed banks or the weakly managed securities firms.

Senator HECHT. Do you agree with that, Mr. Linton?

Mr. LINTON. Well, I must confess that our point of view is somewhat different than Merrill Lynch's, and that is one of our problems within the industry. They, of course, are——

Senator HECHT. Within the banking industry, too.

Mr. LINTON. Yes; they are the giant in our field and their approach to the business is somewhat different.

No, I would try to take a step backward. I don't think that one can go all the way back, but I think that one can take somewhat of a step backward.

Senator HECHT. Mr. Robinson, I'll hear from you now. You had your hand up before.

Mr. ROBINSON. Well, I would not take a step backward. I think the nonbank bank, the limited purpose bank, the reason that we, ourselves, are interested in that field is because it enables us to provide a competitive service with our Gold Card and Signard Travel programs in terms of loans across the country.

So we see nothing wrong with it and it represents a choice. An institution can either choose to limit commercial loans and have a subsidiary which is a limited purpose bank or not.

I think that in terms of legislation, the problem with the House bill is that it goes backwards. In the process of doing that, I think it stifles and delimits creativity and innovation.

As far as the Senate is concerned, an approach like Senator Mattingly has suggested, which seems to politically offer a little something to everybody, would be a preferred direction. It moves in the direction of separate functional regulations.

Senator HECHT. Let me bring this point to all three of you and the difficulty we have on this.

You know your business better than any man sitting at this table today, and far better than any Member of Congress. Yet, you all—Mr. Linton, Mr. Schreyer, and maybe Mr. Robinson—are in the same securities business, not so much Mr. Robinson.

But if you cannot work it out, your different problems, yourself, you cannot come to Congress and say, we can't agree on what's good for the securities industry. You make the laws.

Mr. LINTON. But, Senator Hecht, there's something very important that we all do agree on, and that is don't give the banks additional risk opportunities. We all agree on that.

Senator HECHT. Mr. Robinson, you didn't say yes on that. [Laughter.]

Mr. ROBINSON. I would have to——

Mr. LINTON. Two of us agree. How's that? [Laughter.]

Mr. ROBINSON [continuing]. To differ somewhat from my esteemed colleague and say there's a bid asked in every market.

Senator HECHT. Mr. Schreyer.

Mr. SCHREYER. As Jim says, there's a bid asked in every market. I want to go back to the basic and say we don't agree within our industry—not that we don't agree within the industry—we don't agree within the industry on how to bring the banks into our industry.

All we are saying, we are saying at Merrill, and I think Jim is saying at American Express Shearson, is that they're in the industry, that they're already there. And we're saying, let's compete on fair ground. Let's compete on equal taxation, equal everything.

I think what will result, there will be some fallout. There will be some problems. But what will fall out will be successfully run firms will do well, large and small throughout the country, and let's go at it.

Senator HECHT. But also——

Mr. SCHREYER. But what I don't agree on, I don't agree on a step back. I don't think that's going to solve anything. I don't believe in little salami approaches that will close this loophole or adding this little extra power to a bank.

So let's take a deep breath and pause a while and then move ahead and do a comprehensive——

The CHAIRMAN. How many more times would you like to testify——

Mr. SCHREYER. Frankly, I don't care if I ever testify. [Laughter.] It's a little more fun than I thought it was going to be—— [Laughter.]

Senator HECHT. Mr. Linton, you wanted to answer.

Mr. LINTON. Well, I just wanted to reiterate—the same situation exists, as you know, between the IBAA and the ABA.

Senator HECHT. Yes.

Mr. LINTON. So within a given industry, there's plenty of room for disparate views.

BANKS IN MORTGAGE-BACKED SECURITIES

Senator HECHT. You mentioned about—very much against the banks being in the mortgage-backed securities.

The builders all around America have said, this is one way they can keep the building industry progressing as one of the biggest industries in America. And they push that very much.

You have been financing high-yield, high-risk companies. What do you have against financing for banks adding to mortgage-backed securities?

Mr. LINTON. Well, as I said, the risk that's involved, first of all, I think the present mechanism that exists shows no shortage of availability of securitizing mortgages and bringing them to market.

Quite the contrary—it's gotten so competitive that everybody's looking for new products.

But, believe me, it is a very difficult and very risky business. One of our quite well financed competitors went out of business over the GNMA problems that they had in particular and now part of this great octopus is sitting on my right. [Laughter.]

These are very, very difficult businesses. Taking in these physical securities has great risk. They are rather unique in their return of capital at the same time that they are paying dividends and they require tremendous inventory-taking.

Now the banks have enough risk in the interest rate environment that they're in. Why should you allow them to hold what would be billions of dollars of mortgages while they are packaging and securitizing them and taking the risk?

You must own them. This is not an agency business. One is not a middleman. One must be a principal in order to prosper in that business.

And so I reiterate—sure the banks need more profits. But they don't need more risks.

Senator HECHT. Do you agree, Mr. Robinson?

Mr. ROBINSON. No, Senator. The housing industry has a legitimate concern. How do they maximize the institutions who are helping attract and generate and regenerate and recycle moneys coming into that industry?

I think that if you're going to allow some banks to go in it, then you've got to be careful that they're not simply taking money that is guaranteed by the Federal Government in the form of FDIC in-

surance like when a Continental Illinois has its problems. There, the Government is the silent marketing partner who has all the downside risk. It bailed them out.

So the question of a risk profile of a bank's asset or liability side of the balance sheet, because you can have problems just from mismatching securities, is something the regulators have the capacity to look and deal with it.

Through Shearson Lehman Bros., we would expect to be on equal terms with everybody at this table or anybody else who participates in the securities industry. No advantages are sought—and none should be conferred—by regulatory jurisdiction.

If we were in the thrift industry, we would expect the same opportunities, no advantages or disadvantages to the other institutions out there.

That direction, ultimately, it seems to me, brings the most competitive sourcing to the variety of markets.

I understand the concerns. Certainly, if you look historically, whenever there have been expanded powers, institutions have gotten themselves into trouble, either by overinvesting in real estate or what have you. Perhaps the risk element that is there, if they don't regard themselves as guaranteed by the Federal Government, will help straighten some of that out.

So that there's merit to what Mr. Linton says, but looking longer on it, I would think that you can accommodate those kinds of risks so that you can bring more forms of institutions to serve a given market.

Senator HECHT. How about revenue bonds?

Mr. ROBINSON. The same thing.

Mr. SCHREYER. I agree. I agree with Jim.

Senator HECHT. Do you agree with Mr. Robinson?

Mr. SCHREYER. Yes.

Senator HECHT. Not with Mr. Linton.

Mr. LINTON. No, I don't, and I assume that when you get around to the representative of the Securities Industry Association, he will be where we are, representing, I think, the majority of the firms in our business, except some of the largest and those that have been taken over by companies from other industries, like Sears and American Express.

And that would be—you know, Sea First did well enough going out of business without underwriting WPSS bonds. There would have been nothing there to rescue. Again, I get back to the same old theme—making the banks principals, allowing them to be principals in businesses that have risk is 180 degrees, in my opinion, the wrong direction for them to go. Let them straighten themselves out first.

I think we're facing a very dangerous situation right now in their lending businesses that they're in.

Mr. ROBINSON. I think most of these institutions got in trouble the old fashioned way—by excesses either in management practices or appetite, and it had nothing to do with the cross-industry kind of powers.

Senator HECHT. Thank you. My time is up.

The CHAIRMAN. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

Mr. Robinson, I appreciated your reference to "golden fleece." [Laughter.]

I thought I had a copyright on that term and I'll have to charge you royalties. [Laughter.]

STRAITJACKET FOR COMMERCIAL BANKS

Let me ask you about your statement here. You seem to want to put commercial banks in an even tighter straitjacket, making them serve the lower and moderate income levels of the market while giving American Express carte blanche authority, if you'll pardon the pun—[laughter]—to go after upscale markets through it's nonbank bank, which you want to make legal in the form of a consumer bank.

For example, on page 9 of your statement, you shed all kinds of crocodile tears on behalf of lower income consumers who are supposedly being priced out of banking services. You decry the attempt by banks to move into the middle and upscale markets. At the same time, you want Congress to give your firm the ability to offer banking services to your upscale customers through a consumer bank which would operate outside the restrictions of the Bank Holding Company Act.

As an unregulated entity, you could be able to combine those banking services with other financial services forbidden to banks, such as insurance and real estate services.

If Congress really wants to allow a financial services supermarket, why shouldn't we do it directly by expanding the powers of banks rather than letting unregulated firms, such as American Express, into banking through the back door?

Mr. ROBINSON. Well, first of all, it is totally false that American Express is an unregulated firm. We are regulated by more Federal and State authorities than you can shake a stick at. We're just not regulated like a bank holding company.

Senator PROXMIRE. Well, why shouldn't you be regulated like a bank holding company?

Mr. ROBINSON. Because we do not own a bank as defined in the Bank Holding Company Act and the nonbank banks that we own are already regulated and examined by the appropriate Federal and State banking authorities. If we had a subsidiary that was in the full-service banking business of taking deposits and making commercial loans, I wouldn't mind having that subsidiary regulated just like any other bank. I think that would be entirely appropriate.

Now——

Senator PROXMIRE. Well, why shouldn't the parent be regulated the way the parents of banks are regulated?

Mr. ROBINSON. Because I think when you get into regulation of the parent, it precludes institutions from being in a variety of business, and once you start limiting choices, then I think you slow down progress in the market.

I would say the same thing, that a bank holding company should be able to be in other forms of business and have that subsidiary regulated by the respective regulator.

So I am not looking for an advantage.

The other point, on the low-income question my testimony also says that it is a bank's choice to concentrate on simply the affluent, the middle, the lower, or all of the above. That is their choice.

But I'm also saying that when they continue to have the advantage, which we don't have, of Federal deposit insurance in some of our areas, that there is an unlevel playing field. In the low-income area, we have probably one of the most efficient means of serving that market in the money order, which is made available to people who don't have banking accounts. It is a highly efficient piece of paper.

Senator PROXMIRE. Well, what's the minimum income level needed to get an American Express card?

Mr. ROBINSON. Well, I don't remember what the exact level is now, but it's in the $15,000 area. But that varies by State. For instance, a school teacher in some small town in the middle part of the country could be a far better credit rating.

Senator PROXMIRE. You need $[illegible]0,000. Well, you just excluded half the American people.

Mr. ROBINSON. That's by choice. We have other products, like the travelers checks, that have no such requirement.

Senator PROXMIRE. Mr. Linton, as you know, as you may know, I've introduced legislation to prohibit federally insured depository institutions from investing in junk bonds; that is, those bonds that are not in the top four investment grades.

Now since banks are already precluded by regulation from investing in junk bonds, the principal effect of the legislation would be to place a similar restriction on savings and loan associations.

Do you oppose that legislation?

Mr. LINTON. Only 180 degrees, Senator.

Senator PROXMIRE. Right.

Mr. LINTON. I think you're going exactly the wrong way. If the banks in Ohio and Maryland, the savings and loans, had had a fair portfolio of liquid securities, they wouldn't have had to shut their doors. The finest performing savings and loan in the country is Columbia Savings & Loan, which is going to earn $150 million of profits after taxes here. And you'll find that they have 38 percent of their assets in high-yield bonds.

GOOD RETURN ON JUNK BONDS

These securities, because they happen to have the word junk on them do not represent any inordinate risk. And you'll find three studies recently done by major universities showing that there has been roughly over the years a 400-basis point advantage in the return on those securities against a 1 percent or, in our research, less risk in terms of the chapter 11 situations that have existed.

So, we think that the Garn-St Germain bill did a great service for the S&L's in allowing them to have a certain amount of their portfolios liquid rather than being tied up in real estate and/or commercial loans.

Now where we do come out is that these S&L's, like any other professional investors, need to know what they're buying, need to be diversified, need to have a staff of people that understand.

Therefore, we would go for higher capital requirements, and, if you want, reserves against securities or investments of any kinds based on the risk.

So we would regulate them differently, but we sure wouldn't cut down on their ability to own these liquid loans.

Senator PROXMIRE. Well, at the same time, you argue that high-yield bonds or junk bonds, whatever you want to call them, are safe investments for S&L's, you argue that underwriting municipal revenue bonds, even AAA issues, is too risky for commercial banks.

Isn't that a contradiction?

Mr. LINTON. No; we don't say they're safe investments. We say that over a period of time, the return versus the yield will much more than make up for the risk. There are going to be bankruptcies in that industry from time to time.

Now in the banking industry, the commercial banks are pretty fragile. When you're talking about underwriting them, you've got one set of risks. When you're talking about owning them, you've got another set of risks. The major risks are in underwriting them.

And in the half dozen problems that we've had against the hundreds and hundreds of underwritings that we've done, we have stood there with all our people reorganizing those companies.

We just finished one that after 2 years of enormous work, we're getting 95 cents back on the dollar. But we were hanging out there with a multimillion dollar risk and several lawsuits.

Now I wouldn't put the banks in that position. So, as I say, owning them should not be confused with underwriting them.

Senator PROXMIRE. Well, I think you're right. I think owning them is more risky than underwriting them.

Mr. LINTON. No; that's not what I——

Senator PROXMIRE. In underwriting, you're only exposed for a few weeks; with ownership, you can be exposed for years, 20 or 30 years.

Mr. LINTON. You see, if you own a diversified portfolio, the record will show you that 1 out of 100 investments will go south. You're not going to be hurt that way.

When you do an underwriting, you are underwriting for, if it's 1 week or whatever it is, 100 percent of the risk of that issue, which in recent cases have been beyond $1 billion.

We did $1.3 billion for Metromedia, $1.2 for Occidental. We're just registering another $1 billion-plus deal for Storer Broadcasting.

If you want the banks to take those kinds of risks, I think it would be a great mistake.

Senator PROXMIRE. Municipal revenue bonds, however, that seems to me to be, whether you're talking about ownership or underwriting, about as safe an area as you can get into.

SURCHARGES ON CREDIT CARDS

Mr. Robinson, you want Congress to regulate hundreds of thousands of retail merchants by preventing them from assessing a surcharge on credit card transactions, even though American Express socks the merchant with a 5-percent fee, which, incidentally, is about twice as high as the bank credit cards.

Now if a retail merchant, in his best business judgment, feels it fair and proper to pass along the cost of the American Express fee to his customers, why should the Congress step in and tell him that he can't do it? Why can't we let the free market operate? If he wants to charge for parking, he can do that. If he wants to charge for altering clothes, he can do that. But if he wants to charge for a credit card, he incurs a cost which is clear and explicit paid to your company, you say that he's not allowed to pass that along.

Mr. ROBINSON. Senator, I didn't know we were going to get into the surcharge area today. But having raised it, let me make one small correction--5 percent is way above what we charge anywhere. So it's not in that proportion.

Senator PROXMIRE. What is your average charge?

Mr. ROBINSON. About 3, 3.4. On the issue of surcharge versus a discount, as you know, we fully support the opportunity for any retail establishment to offer a cash discount if someone chooses to pay in cash rather than use his plastic.

All of the studies that I've ever seen indicate that that provides 100 percent of the opportunities for an institution or a store to distinguish between cash and plastic.

We support that two-tiered pricing system.

Surcharges, on the other hand, are added on top of the purchase price of the goods or services. I guess the distinction is that we have a franchise with our card members. We have led in the area of truth-in-lending kind of legislation, with full disclosure, consumer protection rights, et cetera, and our card members look to us to protect some of their rights. We have no option other than to speak out on an issue like this.

We don't think that the Federal prohibition on card surcharges restricts the operation of the free market. There are an increasing number of States in the country that agree with us, New York being one, and Texas.

So that that's a separate issue from today's hearing and we are comfortable with our position on it.

Senator PROXMIRE. Well, my time's up, but I can't, for the life of me, understand how you could ask Big Brother, the Federal Government, to step in and say that a merchant cannot pass on a legitimate cost that he has to pay for a process that the consumer requires.

Mr. ROBINSON. They pass it along in the form of whatever their pricing structure is now.

Senator PROXMIRE. You want to hide it, though. You don't want him to charge explicitly—and furthermore, they have to pass it on to cash customers and everybody, whether they incur it or not.

Mr. ROBINSON. Senator, we disagree and have for some time.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, let me commend you for your patience in holding these oversight hearings. I guess they've been going on long before this Senator came to this body. I'm not going to beleaguer the chairman and our three witnesses. I'd like to extend to them my thanks for their participation and put a statement into the record.

I'd ask one question of my friend, Mr. Linton.

Bob, testifying before us, before this committee, last week was Lou Preston of Morgan. He made the statement that the making of 10-year loans by banks is much more risky than corporate underwriting.

Would you care to comment on that?

Mr. LINTON. Well, it's very difficult to compare those risks. I am not a commercial lender. Indeed, the record of the banks in recent years would show plenty of risk. I don't think they've been doing their job very well.

I also would point out the discussion we had before you arrived about the 14,000 banks out around the country. In the main, they're not taking those risks. They know their borrowers. They understand the businesses to which they're lending.

In recent years, these major banks have gone out there and done—perhaps not done—their homework as well as they have—and then they've syndicated these loans. Smaller banks have joined those syndicates without really knowing what they were doing. We've seen documentation in Continental Illinois that they had oil loans without ever having any proof that a well existed. And many times it didn't exist.

So I don't minimize the risk in the commercial lending that the banks do. Is the answer to that to give them more risk? I say no. Let them straighten out their mess in their bank loans before you talk about letting them take the additional risk of underwriting.

Senator D'AMATO. It would appear that there might be an inconsistency in your position as it relates to the issue of curtailing commercial banks in riskier activities as a result of the fact that there is Federal insurance. From that stems the fact that the Government, in essence, and the taxpayers are guaranteeing the possible risk inherent with expanded activities into new areas. Jim Robinson has suggested, for example, separate subsidiary under the same regulator, even playing field. I think Al agrees with that.

Having said that, though, I know that at least one of my colleagues would feel that that is true. If your position in terms of opposition to commercial banks getting into these activities, then why would that not be the same case as it relates to the thrifts, particularly those that have Federal insurance, FDIC. Isn't that an area of nontraditional activity in which, to whatever extent they're involved in this area, FDIC, the Government is underwriting?

Mr. LINTON. Absolutely. We certainly don't advocate that the thrift industry enter into any of these new activities, if that's your question.

Senator D'AMATO. Well, no.

Mr. LINTON. If you're talking about——

Senator D'AMATO. More precision with respect to, and I'll use the word high-yield bonds.

Mr. LINTON. Thank you.

Senator D'AMATO. Was that a good question, Mr. Chairman?

[The Chairman nods in the affirmative.] [Laughter.]

SAFETY WITH THE LIQUIDITY OF SECURITIES

Mr. LINTON. As I've said before, Senator D'Amato, you, in your bill of 2 years ago, the Garn-St Germain Act, created the opportu-

nity for the savings and loans to put a certain amount of their money in liquid securities. Now that's my idea of a forward step. They're able to go in there as open investors, decide what they want to buy, get a higher yield commensurate with somewhat of a risk. But if they want to get out, they sell the securities. If they have a problem and they need to raise money, they have a market to sell those securities. They don't have that with their real estate investments or with their commercial loans.

So because they don't have an investment rating, I don't think that one should be associating an outside risk or a risk that is not commensurate with the yield that they're getting.

Senator D'AMATO. Do you see any area where maybe Congress should take legislative action to ensure, for example, that those S&L's that are so thinly capitalized and are already rated as endangered species by the Comptroller and others, that there be some restrictions with respect to their undertaking investments in the high-yield area?

Mr. LINTON. Well, not directly. And whether this comes from the Congress or the regulatory authorities, I wouldn't know. But we do advocate an increase in the net capital requirements of the thrift industry. Not one that——

Senator D'AMATO. Well, isn't that—whether we say we recommend that there be standards for those who do not have sufficient net capital to not be permitted to enter this area.

Isn't there a corollary? Couldn't you say, generally, those banks that are in very, very poor net capital position, maybe have questionable management?

Mr. LINTON. No, quite the contrary. You find most of the high-yield bonds that are owned by thrift institutions are owned by the best run, best managed, most profitable institutions.

Senator D'AMATO. You're not listening—OK. So what would be the objection to indicating that, for example, if someone was totally undercapitalized and was on the endangered species list, that they would be restricted in terms of handling high-yield securities. I suggest to you that one of these days, when a number of these go under, and they will, they're not going to go under as a result of their investments necessarily in high yields. But that will be the cry. The fact that they were poorly managed for 6, 7, 8, 9, 10 years and got themselves in this position, and then the final straw that broke the camel's back may have been an investment in a bond that no one would have undertaken, unless under poor management, that's going to then call for the cry of saying, let's ban S&L's, let's ban the thrifts from entering into this area.

Don't you see that?

Mr. LINTON. Yes; but I don't think that it makes any sense. Are you going to ban them from putting——

Senator D'AMATO. No, no. That's what you're saying.

Mr. LINTON. OK. But let me ask you, if I may——

Senator D'AMATO. I didn't say that.

Mr. LINTON [continuing]. Senator——

Senator D'AMATO. What would I do?

Mr. LINTON [continuing]. Would you ban them——

Senator D'AMATO. I'm going to give you a good one.

Mr. LINTON. Would you ban them from making investments in real estate development companies? That's where they're getting killed, on the real estate development side.

Senator D'AMATO. No, no, no, no. Let me suggest to you that if you have someone who's totally undercapitalized, who's got negative by any standard——

Mr. LINTON. All right.

Senator D'AMATO [continuing]. Who's never demonstrated—would you give them expanded power? Don't you think that in those areas, for example, those banks—I think they rate them 3, 4, and 5—that they not be allowed to participate in these activities. Those that show some capital and net worth be given the opportunity to participate. As that net capital increases, that the participation, the percentage be increased as well, and that there be some rules with respect to investment in requiring some diversification? Wouldn't that——

Mr. LINTON. Yes, I wouldn't disagree. That's what we do in our industry. And their capital should be increased and there should be haircuts applied according to the viability of each investment. Their commercial loans should have a certain haircut. Their real estate should have a certain haircut. And their publicly traded securities, according to their ratings, should have a haircut. And that should relate to their capital requirements and they should be marked to the market, a point I made earlier. And by doing that, you'll give them the kind of security that exists in our industry.

Senator D'AMATO. So do we agree, do you and I have a meeting of the minds on one point. Let's go back to it—that if you have an S&L, a thrift that is poorly capitalized, that's on the endangered species list, that that institution should not be engaging in a wider variety of activities, high-yield bonds?

LOSSES MOSTLY ON REAL ESTATE SIDE

Mr. LINTON. Not at all. I would say that that probably is the least risky part of their investment. If you examine them and find where their losses are, you're going to find them, as I said, mostly on the real estate side.

So by having the proper regulations, you put the proper haircuts according to the amount of risk of the investments.

And your statement, for me to go along with that, I would have to agree with you——

Senator D'AMATO. Well, that's the area that we're moving into.

Mr. LINTON [continuing]. That the relative risk in investing in those liquid securities is greater than the risk in their illiquid——

Senator D'AMATO. I'm not asking you to state that at all. But let me just suggest to, and I know I'm running out of time here, that there's something called management.

Mr. LINTON. Sometimes.

Senator D'AMATO. And if you're going to allow people to go into an area where the management hasn't proven itself to be adept at handling these transactions, whether they go out there and make a bad loan or not, then it would appear to me that there must be some standard by which the Congress and others can assure that we're not going to allow people getting into these activities where

they haven't demonstrated the capability to do that which has been traditional first.

I would also suggest to you that if you oppose the kind of thing that I'm suggesting, and you're being rather short sighted, some of my colleagues who are at this hearing will go further—they'd ban all of them from undertaking this where there's Federal insurance.

So what I'm suggesting is that those of a demonstrated capacity who show a good capital base, be allowed and even given enhanced ability for investment in these areas, that those who are on the endangered species be barred from it.

Mr. LINTON. Well, we don't disagree completely because——

Senator D'AMATO. I didn't think you would when I put it that way.

Mr. LINTON. By raising the capital requirements, you will get where you want to go. If they don't have room within those capital requirements to own those securities, then, de facto, they're not going to own them.

So let's get there by regulating them the way we're regulated, in terms of their having adequate capital to sustain the kind of surprises that they seem to come up with.

Senator D'AMATO. It took us 10 minutes to get to that point. [Laughter.]

Thank you, Bob. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Mr. Schreyer, in some of your earlier remarks, you were alluding to what you refer to as problems in the banking structure.

What are these problems, as you see them, and where are we going in the banking structure?

Mr. Linton, I believe, made that statement. I beg your pardon, Mr. Schreyer.

Mr. SCHREYER. Yes.

Mr. LINTON. Well, all one has to do is read the newspapers to see what has happened. There's been a tremendous deterioration in the quality of the collateral against which the banks have been making their loans, whether it's foreign loans or whether it's agricultural loans, anticipating higher land prices which didn't materialize, or whether it's oil-patch loans or whatever part of it you want to pick.

We feel that reflects nothing more or less than poor judgment on the part of those lending agencies. We're plenty concerned about it.

Senator SASSER. Well, you point out, I think quite rightly, Mr. Linton, that public confidence is fragile. And once shaken, it's very difficult to restore. I think that's true in the banking industry, certainly.

We've seen failures also in the unregulated Government securities sector. The failures of ESM and Bevill-Bressler have had a ripple effect on several sectors of the financial community, it appears to me. And there has been some degree of loss of public confidence.

What should be done about these unregulated dealers, since they do have the ability to affect public confidence in the entire system?

Mr. LINTON. Well, first of all, Senator, unfortunately, you can't legislate against fraud. And in most of those cases, it's been fraud

that has taken those institutions down. I don't think any of us are smart enough to know what to do about that.

But I do feel that there is a need for regulation among the nonreporting dealers in the Government bond market and whether it turns out, which agency, as between, in particular, the Federal Reserve Board or the SEC does that, we have no opinion.

But we do, indeed, think they should be regulated as the reporting dealers are.

COMMITMENT TO FORGOTTEN CONSUMERS

Senator SASSER. Mr. Robinson, I've read your statement with interest. I apologize for being late here this morning and not being able to hear the delivery of your statement. But I did note you were discussing a commitment to the interest of the consumer and you referred to the forgotten consumer in a portion of your statement.

You suggested that there were three things that could be done to help this forgotten individual. First, access to the broadest array of financial services and choices. Second, credit at a reasonable cost for all Americans. And third, you said, the essential safety and soundness of the financial system.

My hunch is that those who are standing in line in Ohio and Maryland to try and get their savings out of the S&L's are not as much concerned about an access to the broadest array of financial services or reasonable credit costs as they were to essential soundness of the financial system itself.

Don't you feel that the business of having a safe and sound financial system probably ought to be at the top of the list if we're concerned about consumers?

Mr. ROBINSON. Well, I would say that without that, you don't have a world. So I would agree with you that safety and soundness is paramount and the rest would flow from that.

It's in American Express' best interest for a safe and sound system to exist, as it is for any institution or company.

I would tend to look to the kinds of techniques that Mr. Linton was mentioning. And that is techniques which require marking to the market, which empower the regulators, whichever they may be, to establish capital ratios, to set in the process capital ratios based on different risk characteristics—therefore, haircuts—in terms of how much one form of investment or another qualifies in meeting that capital test. All of those things are in existence now. Just use them.

And if they're used properly, I think they can allow the safety and soundness fundamentals to be in place. And with that, then what you want to do is to encourage innovation, to encourage maximizing choices. If one form of institution, because of whatever its unique problems, chooses to move out of a market, like mortgage markets, then create the opportunity for others to come into that market.

The consumer bank, or nonbank bank, for instance, in the credit card area. If some institutions choose to keep their interest rates up higher than the market might suggest, allow others to come in and provide the service. Don't keep them out.

Senator SASSER. Mr. Schreyer, you particularly referred to the Glass-Steagall separation between commercial and investment banking, noting that the abuses and tie-ins between banks and their underwriting affiliates led to the adoption of Glass-Steagall in the first place.

Do you see any of these same abuses occurring today?

Mr. SCHREYER. Not really. But what I'm saying is that the reason I said before Glass-Steagall, rather than have it dismantled piece by piece, that the really comprehensive look should be done, raises the questions of possible abuses, of concentration of economic power, much like the German system and so forth.

I personally believe, though I wouldn't want to vote without doing some more work on it, I personally believe that with the tough regulation, that we can have the antifraud provisions, the Justice Department—I think all the machinery is in position that would prevent this.

So if I were to gamble on it, I would say, no, although I would have to say that the potential for abuse is clearly there and it should be examined carefully.

Senator SASSER. One final question. What's the difference, Mr. Schreyer, between a bank offering securities products and a securities firm offering banking products, such as checking or CD's?

Mr. SCHREYER. What is the difference? Well, I like to look upon our cash management account, which is what I think you're referring to, that we developed some years back. We have 1,200,000 customers. I simply say that the bank-like activity is giving our customer access to his investment funds through either a check-writing privilege or a debit card, the VISA card.

So that that is the bank-like—so that, really, that has been—by the way, we carried this through every State and it was approved in every State. And it was determined under the rules, it was not making commercial loans or taking FDIC-insured deposits.

So, that is what it is. And you say the banks do the same thing. Well, yes, they do the same thing. There's nothing wrong with that.

Senator SASSER. Gentlemen, thank you.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, thank you.

I've got a couple of questions. And I guess the first question I should really direct to Mr. Schreyer and Mr. Linton, inasmuch as it's more related to their lines of expertise and ability to assess risk.

As you know, the bill passed by the Senate last year had four additional powers, financial services powers, granted banks—commercial paper, discount brokerage, the underwriting of municipal revenue bonds, and mortgage-backed securities.

RISKS OF FOUR ADDITIONAL POWERS

Which of those are the riskiest lines and which are the least risky, and why?

We'll start with Mr. Schreyer.

Mr. SCHREYER. In terms of risk, discount brokerage certainly is not a particular risk. It's a nonbroker broker-like activity.

Senator HEINZ. I guess we might as well focus on the other three——

Mr. SCHREYER. Yes.

Senator HEINZ [continuing]. Because I think——

Mr. SCHREYER. Then you say the municipal bond revenue, mortgage-backed securities, and what was the third?

Senator HEINZ. The commercial paper.

Mr. SCHREYER. Commercial paper.

Senator HEINZ. Underwriting.

Mr. SCHREYER. I would agree with Bob Linton that the highest risk, because of the nature of the product, would be the mortgage-backed securities.

Senator HEINZ. What would be second?

Mr. SCHREYER. Next? Well, I guess—well, I think commercial paper would be the least. So you'd have to put the other one in the middle, would be my guess.

Senator HEINZ. Would you agree with that assessment, Mr. Linton?

Mr. LINTON. Yes, I would.

Senator HEINZ. Thank you. One of the issues we also debated last year, we decided not to incorporate it, was the question of whether banks should be allowed by the Federal Reserve Board to engage rather than in the limited definition of activities closely related to banking, whether that should be broadened to a definition that is "of a financial nature."

What would that term mean? What, as you understand the language of your professionals, would activities of a financial nature include?

Mr. LINTON. Well, I think that that's a conundrum. I, for one, certainly don't have the answer to that question.

But, again, I get back to the theme that I've been espousing over and over again, and that is assess the risk.

Senator HEINZ. Well, we don't know what it means. It would be hard to assess it. [Laughter.]

Mr. LINTON. No. But as the Federal Reserve would propose that the banks be allowed into a given business, I would say, what's the risk? What's the down side, because that's what you must protect them against. And if it's a pure agency, middleman kind of a transaction, that's one thing.

Now, we have that argument going on in the courts now in terms of commercial paper. The question really was in the *Bankers Trust* case, were they an underwriter, which is a risky end of the business to be in, or were they merely acting as agents?

Now, it was determined by the courts that commercial paper is a security. Therefore, they may not be an underwriter. But the interpretation of the Federal Reserve in the most recent case, as I understand it, is that the bank was acting strictly as an agency, a middleman. Therefore, it was their right to be in that activity.

I generally agree with that. If they are acting as a middleman, as they would be in the brokerage business, fine. But if they are acting as a principal and taking additional risks to what they have now, I would say no.

And before you got here, I did make one point I'd like to make again. The whole impetus for allowing them into this business, at

least by some, and most recently by Secretary Baker at your committee last week, was let the banks do these things in order to create profits. They'll then be safer and sounder.

But the profits are exactly commensurate with the risks. And if they want to get where the profits are, they've got to get where the risks are. That's where the spreads are and that's where you make your money, not just as an agent.

Senator HEINZ. Is risk the only criterion by which we should judge additional financial service powers to banks?

Mr. LINTON. Well, it would be the heart of my policy, if I were sitting in your seat.

Senator HEINZ. Should we——

Mr. LINTON. Only—I wouldn't say only—but it would be——

Senator HEINZ. Should we have any concern over conflict of interest, tie-ins, those kinds of issues?

Mr. LINTON. Absolutely.

Senator HEINZ. How do you measure those?

Mr. LINTON. Well, I think they're important. I believe that there must be equal competition, so that if the banks are allowed in certain of these businesses, then they have to be regulated and taxed in the same way as their competitors.

So I think those things are important.

Senator HEINZ. Well, is your answer to my question, you can't measure them, but you can regulate them through a separate subsidiary?

Is that what your answer is?

Mr. LINTON. No, no. I think that in many of these businesses, they can be regulated, and I think they should be SEC-regulated along product lines. That's what Mr. Robinson was suggesting, and I would agree with that.

Whoever, whether it's the CFTC, or the SEC, or the Federal Reserve Board, whoever is regulating a certain product, should regulate all of those who are dealing in that product.

But those middleman activities I think can be regulated and can be handled.

Senator HEINZ. So the answer is ask the regulatory agency that might have jurisdiction over securities, the SEC, to specifically regulate against conflicts of interest and tie-ins.

Mr. LINTON. Well, I think that is part of the answer. I think that is part of the answer, yes.

Senator HEINZ. Mr. Schreyer, do you have anything you want to add or, for that matter, Jim Robinson?

DEFINING FINANCIAL

Mr. SCHREYER. No, I agree. In the first, part, when you said, how do you define financial, I have to think about that. But you look upon Merrill Lynch, for example, I would define as a U.S.-based investment services firm within the great financial services industries, investment services firm serving individual investors, corporations, governments, and financial institutions as customers, worldwide, as the world becomes more global, which is what it's in the process of doing.

American Express might have a different definition. Prudential is insurance-based. And you can go on and on.

So we all have our spots. We don't contend to be like Bank of America or like Sears, Roebuck.

But I still believe—I'll come back to my conviction that the next step should not be granting one little extra power to a bank or one little less thing to a securities firm or one more thing. I really think the real answer is going to be to take that comprehensive look, take all the suppliers, all the financial institutions, and all the services and products and see what the rules and regulations are for each and apply it equally across the board—strong net capital requirements, strong regulators, strong supervision.

The poorly managed firms are going to fail. That's the free enterprise system.

Senator HEINZ. How do we solve the issue of the access of one set of those institutions to the Federal Reserve window, FDIC insurance, Fed wire——

Mr. SCHREYER. That's right.

Senator HEINZ [continuing]. And a variety of other advantages? If those things didn't exist that I just described for you, I'm sure it would be a lot easier.

Mr. SCHREYER. A lot easier. It would be a lot easier.

Senator HEINZ. But, unfortunately, life being what it is——

Mr. SCHREYER. It's there.

Senator HEINZ [continuing]. Complicated, messy, imperfect, those particular advantages accrue to insured institutions.

How do we take them into account, because the grid that you, the conceptual grid that you just superimposed doesn't take that into account.

Mr. SCHREYER. Well, if it didn't, then it could, if you look down and see what's needed to make everybody have the same compliance.

The reason for the New Jersey nonbank bank, all the banks in New Jersey do have FDIC insurance. We were granted the authority to open this nonbank bank, limited service bank, providing we applied for FDIC insurance.

Now by having this, it would give us entry to the Fed payments system. It would do all these things that you just described. Without it, we're not eligible to have it. And therefore, we have to do it through a bank, which means that it's cumbersome, which means that it's more expensive, which means that if you try to correct an error with a client, you have to bring in the third party, et cetera, et cetera.

So if you give everybody the same opportunities, then we can compete and the beneficiary, I still say, will be the financial consumer, as he's proven to be so far, with a lot of heartache in the meantime.

Senator HEINZ. Any of you want to add anything to that?

[No response.]

Senator HEINZ. Very well. Mr. Chairman, I think I'll set a record and say my time has not yet expired, but that's enough questions.

The CHAIRMAN. Senator Dodd will appreciate that.

Senator Dodd.

Senator DODD. Thank you, Mr. Chairman.

I think you pretty much covered the waterfront here once again. I told the chairman yesterday, I think we're maybe going to come up with an award, a Sisyphus award.

Mr. SCHREYER. Which award?

Senator DODD. The Sisyphus award. [Laughter.]

Rolling that rock up to the precipice, only to have it roll back down again, and have to roll it back up year in and year out.

Just a couple of points.

The CHAIRMAN. I'll hold our next hearings in space where there's zero G and it goes either way rather easily. [Laughter.]

Senator DODD. I'd be careful about that one, Mr. Chairman. [Laughter.]

Just a comment, I guess, and then I'll even break a further record, Mr. Chairman, and let our second panel get on here. This back and forth, the competitive equity question, the question of risk, and what we do sitting at this particular table.

Mr. Linton, your comment about if you were sitting here, is what we've got to wrestle with. The competitive equity question is certainly an appealing one, and an argument that's appealing as well. Too few times, I think those of us who sit up here, sit in this body, generally, forget that our real concern, aside from your particular industry, is the people you serve—your deposit customers.

Rarely are we invited to speak to a group of depositors. They don't provide too many honoraria. Very few conventions for consumers.

And so our tendency is to constantly focus on the industry side of this thing without really stepping back a bit and saying our real responsibility and obligation is to the people that you serve and we serve.

PROTECTION OF THE DEPOSITORS

What do we do in such a way that will allow you to succeed, obviously, from a business standpoint, but simultaneously, and more importantly, from our perspective, to guarantee to the extent we can guarantee that the people that rely upon your institutions to protect that which is the most important thing in their lives, aside from their families—their financial security?

And that really is where we kind of wrestle back and forth. For me, anyway, I've said in the past, the level playing field notion, which has become a cliche, I guess, unfortunately, in some ways—I don't say this too facetiously, but I once said that I thought that the fact that the coliseum in Rome had a level playing field was probably of very little consolation to the Christians in their day. [Laughter.]

And that idea of having a level playing field is one aspect to all of this.

But the risk question of how you protect against the possible loss to the people who rely on those institutions is really the far larger one.

I guess, in a sense, I find the panel here this morning, it's somewhat interesting that, Mr. Linton, you take the much more traditional view of the securities industry and Mr. Robinson and Mr. Schreyer are the other side of that proposition, with the chairman

coming somewhere in between, in a sense, having limited exemptions and sort of carving out, if you noted, various areas from each other and going along in that fashion.

We've been 4 years at this now, the chairman trying to, really, in a very—even though we disagree on some points—really talking about three or four powers. I mean, it isn't a sweeping kind of proposal when you think of it.

The CHAIRMAN. Only to the opponents. [Laughter.]

Senator DODD. Well, I mean, there's that aspect of it. I wonder—and I'll just ask the three of you this—if you could give me some sort of a conceptual framework of how you might, if we were to pursue what the chairman was doing, in a limited way, be able to protect that consumer from the kind of risks associated with limited expansion into each other's particular arena?

How would you confront that problem?

Mr. ROBINSON. Well, again, I think separate subsidiaries, and functional regulation, something like the Mattingly approach, is a step in that direction. It preserves the opportunity for consumer banks to exist. It modifies at the margin without going all the way. But it preserves that general concept.

Senator DODD. Mr. Linton

Mr. LINTON. Well, I guess I get the Dead Horse Award. [Laughter.]

But I would try to protect the consumer by limiting the risk of the banks. When a person deals with a bank, he expects to be secure. And to the extent possible in the creation of rules and regulations and laws, he should be protected. And I think that that has to be understood.

We look at our banks in a very different way.

Now, I want to tell you something that just happened. Morgan Stanley underwrote a high-yield bond 7 or 8 months ago called Oxoco. And they didn't make their first interest payment. The company went into bankruptcy 5 months after this $250 million financing.

Now contrast that with Morgan Guaranty having done the same deal. People that deal with members of our industry walking in the door know that they're dealing with risk. We deal in risk. We deal in securities, which, by definition, have risk, varying amounts of risk, albeit, but risk.

When you deal with a bank, you're entitled to get your money back. You're entitled to be secure.

So I say protect the consumer by limiting the risk of the banks. What's happened in the last 4 years, unfortunately, since we started all these discussions, is that the banking situation has deteriorated mightily.

So I say even more so, don't let them in any doors behind which lie any additional risk.

Mr. SCHREYER. Well, again, I agree that if you follow Bob's prescription, he is dealing with what has been traditional and right, and properly so, in the past. But I think we've got 5 million individual customers and we've organized our firm to serve the needs of that particular customer. Let's forget the corporation, financial institution, and Government. Let's just talk about the individual.

So there are all kinds of individual customers. You get people who can afford to speculate and take a higher risk and you've got those who have a right to expect to have a safe investment, whether it's a short-term Government security or whatever it might be. You can go to extreme cases of conservatism and safety to very, very high risk.

So I think that the way the world's going, we simply can't try to hold back the tide of deregulation, competition, and the fact that the consumer is going to ultimately be the beneficiary, but there will be risk in doing this. And poorly managed financial institutions on either side will not do well for their customers or for themselves.

So I think—I'll stick by and plead for the thing that I pleaded for this morning—that we not do it piecemeal, but let's have it totally fair, equal, and competitive. Strong and well-managed institutions will deliver to the consumer. And the financial consumer today is far better off than he ever has been before, far more knowledgeable.

You know, when the market funds started, our ready asset trust was the first. We never had one advertisement in ready asset trust, not one ad. People were sophisticated and knew that 5¼ percent down the street was not as much as a money market fund.

And so it grew. I think this whole thing has been a marvelous development for the financial consumer.

Senator DODD. Thank you, Mr. Chairman. Thank you.

The CHAIRMAN. Gentlemen, just a few more questions and then we'll let you go.

SALAMI APPROACH

Mr. Schreyer, you picked up the term from one of my colleagues, "salami approach." At the same time, we have talked a good deal today about repetition.

There's some conflict in what I've heard. We started out talking about redundancy and repetition. This debate, as I have said many times, and I'll be redundant, has been going on since before I became a Senator. And yet, after having heard all of that, and I interjected just once, how many more times you wanted to testify—you're one of those who is saying, let's be cautious. Let's be careful.

Now, is that another decade?

Mr. SCHREYER. No.

The CHAIRMAN. Do you want to testify for another 10 years?

I have tried to push comprehensive legislation and balance that as best I can. And yet, now I'm told it's a salami approach, not through my choice. My original bill was cut down. This bill was cut down. I would have gone further, faster, and I make no apologies for that because the marketplace has gone a heck of a lot faster than Congress has by years.

Mr. SCHREYER. That's right.

The CHAIRMAN. So what are you saying to me when you say comprehensive approach, but let's be cautious—10 years from now?

Mr. SCHREYER. Well, I don't think I used—I hope I didn't mean be cautious in the sense of not doing anything. I'm merely saying you've heard 4 years of testimony.

The CHAIRMAN. Well, that's why I asked the question.

Mr. SCHREYER. It's the right question. Where do you go from here?

You've had this testimony for 4 years. You've got the views of the large banks and of the small banks, the country banks, and the various constituents.

The CHAIRMAN. We've got everybody's views. [Laughter.]

Mr. SCHREYER. Every view. So I'd stop the testimony. You're probably sick of it, anyhow. And God knows, you've heard all the angles.

So I think—I don't know what the process is. I'm not familiar with it. But it seems to me that rather than just add on the fact that a bank can do revenue bond, do the whole thing. But come out with more than just regulation of what they can do. Come out with the equal, competitive situations so that one doesn't have—I mean, cover all—an unfair tax advantage or different rules for FDIC insurance, et cetera, et cetera. And do it in one comprehensive bill.

Now that may take 6 more months to get it done right, but don't do it a little bit at a time.

The CHAIRMAN. Well, I would love a bill that comprehensive.

Mr. SCHREYER. I'm with you.

The CHAIRMAN. But that's not possible to do. The major argument made against my present legislation has been that it is too comprehensive. So take that kind of a bite all in one piece—this Congress will never swallow it. I can't get them to swallow the small chunks, let alone—but I'm glad to hear you say that you're not opposed to moving ahead.

Mr. SCHREYER. I'm not.

The CHAIRMAN. There was a time several years ago, so, OK.

Mr. SCHREYER. No, move ahead.

The CHAIRMAN. OK. That clarifies that.

Mr. SCHREYER. But not in one little piece. Just as much as you can get done that makes us equal and competitive and let the competition begin.

The CHAIRMAN. The other argument that is used over and over again, as I've said so many times, to try and achieve some fairness and so on, is safety and soundness.

Mr. Linton, you have repeatedly been more articulate today about risk than any witness I've had before me in a long, long time. I don't disagree with you. Safety and soundness is important. Everybody does. But I want to ask you—what is so much more risky in mortgage-backed securities—you mentioned to me yesterday privately and today publicly that you might have to hold them for 90 days.

Why is that more risky than a savings and loan or a bank being stuck with it for 7 to 30 years? The whole purpose of developing a secondary mortgage market is to allow these people to exist and to get rid of those in some other form in a secondary market. Then they don't have to carry the very risk that put the whole thrift industry on their back because of being stuck with low-rate, long-term, fixed-rate mortgages.

But today, I heard from you that this is the most risky thing anybody can do. But it seems to me that it makes a lot more sense for them to be able to market those in one form or another, even if

it takes a whole 90 days. And most of those issues that I've seen are presubscribed. People are smart enough to assess that risk and start finding out what kind of a market exists and boy, they go pretty fast with most of them.

But even if you hold them 90 days, why is that more risky than 7 to 30 years?

Mr. LINTON. Well, I think it's apples and oranges, Senator. Theoretically, somebody that's running a thrift institution is supposed to be smart enough to create money at a cheaper price than they're lending it. That's their whole ball game, and that's part of what's happened. These mismatches that have taken place are nothing more than mismanagement.

And so, there shouldn't be a risk in those long-term loans that they make because their job is that they're supposed to create the funds cheaper than they lend them out. And they've forgotten that. Sure, there's risk there. There's plenty of risk there because they're doing a lousy job. They are mismatching.

Wen you look at the two sides of the ledger in these thrift institutions, you say to yourself, how the hell can a banker with any brains allow this situation to exist?

I can't answer that question.

Now I don't think that's comparable to buying a $500 million package or mortgage securities and holding that package for a period of 30 or 60 days while you compartmentalize it and find buyers for it and are taking an interest rate risk. It's a completely different kind of a risk.

I would say, one, kick a few butts in the banking industry and find——

The CHAIRMAN. Let's kick a few butts in the securities business, too. You're making a case that is so overexaggerated on the banking industry, I'd be ashamed to be sitting there making that case today.

Mr. LINTON. Well, then, why are they going broke on their depositors?

The CHAIRMAN. The vast majority of the banking industry is not going broke, Mr. Linton. It simply is not. You can pick out isolated examples.

Now I want to know if you think Penn Square, Continental Illinois failed because of deregulation?

FAILED BECAUSE OF MISMANAGEMENT

Mr. LINTON. I would say they failed because of mismanagement.

The CHAIRMAN. You're right. But you use those failures and examples, and you and many of your cohorts use that as an example for doing nothing but to protect your own turf in the securities industry.

Now, securities are so damn safe—or so risky, as you say—why don't we call them riskettes instead of securities or something.

Mr. LINTON. Well, you can call them what you want. But nobody comes to our rescue if we do have a problem. That's the whole nub of what we're talking about.

The CHAIRMAN. We got in trouble in Ohio because of a securities firm in Florida.

Mr. LINTON. That was fraud and they were in the Government bond business.

The CHAIRMAN. That's right. That's right.

Mr. LINTON. And that has nothing to do with what I'm talking about. We don't have FDIC money. We don't have Federal Reserve discount windows. And nobody comes to rescue us when we go broke. And plenty of security firms have gone broke.

The CHAIRMAN. What I hear from you——

Mr. LINTON. But the customers have not gone broke.

The CHAIRMAN. You want a 25-year-old banking system, but allowing the securities industry to do anything they want; right?

Mr. LINTON. No, I don't want a 25-year-old system. I want a system——

The CHAIRMAN. Well, that's what you're telling me. You're telling me for them to learn to do what they've traditionally done and do nothing else, which is make commercial loans, mortgage loans, automobile loans, and things like that and stay out of any risky ventures that you're in because that is the province of the securities industry.

Mr. LINTON. Yes.

The CHAIRMAN. You know what? I agree with you.

Mr. LINTON. Risky ventures? Yes. But I am not talking about, for example, the brokerage business. There have been many, many changes. And if, indeed, they act as an agency in commercial paper, I don't have a problem with that because there's no risk in that, if they're, indeed, acting as an agency.

But when you get to risky ventures, I say keep them out of it. You have enough problems as it is. And even though those few that you mention are symptomatic, there are plenty more out there that give one pause.

The CHAIRMAN. I don't disagree with you in principle. The thing that's getting my dander up a little bit is the double standard that occurs as I listen to the testimony.

I heard it yesterday from the insurance people, with the exception of a few, who say, keep the banks out of the insurance business, but for heaven's sakes, let us be in the banking business. And you know that standard exists.

And we had a few who said, no—the president of Equitable sat there and said, no, I'd love to get out of the banking business if you'll keep them out.

OK, that's fair. That's what I've heard from these two gentlemen today. They have been defending their turf, and they should. And each of you should. Nobody else will do it for you. I don't disagree with that. But at least they're realistic enough not to pull the wool over people's eyes and say, OK, we realize that there's some unfairness here. And we're willing to compete. They're concerned about risk, too. But you're giving—the line I'll hear from the SIA in a few minutes is let us do any damn thing we want. Let us raid. Let us pillage. Let us have the guerilla raids into the banking business. But then raise this motherhood issue of safety and soundness and keep them out of risk.

Well, if you could put that genie back in the box where you had the pigeon holes in the rolltop desk and everybody was doing their thing in a nice regulated way, fine. I'd agree with everything you

say today. But to see this going on and for you to come and tell me today over and over again about the riskiness, I fully understand. I'm a little bit involved with that on a daily basis, in the FDIC and the FSLIC and the trouble list, and I worry about it. But what condition would the thrift industry be in today if we hadn't removed regulation Q? Yet, I heard the same arguments then—don't do that. Don't let them compete with us, from most of the firms. There are a few stalwarts, like some here, like some of the insurance people yesterday who will admit that they were protected by Government.

Mr. LINTON. Well, I can pull out testimony on getting rid of regulation Q of mine that goes back a lot of years. All I'm saying is keep these industries separated. I'm not coming from the same place that these two fellows are. And you've got to understand that if this testimony on my right were being given by an independent Shearson Lehman, it might be closer to what I'm saying than it is a part of American Express.

They are in a different business than we're in. And Merrill Lynch, to quite an extent, is in a different business than we're in.

So from my point of view, I say, yes, I'm a reactionary. Keep these businesses separated. I'm not looking for any advantage. I have no interest in our going into the banking business at all. Keep them separated, as they should be, and regulate them properly.

The CHAIRMAN. Are you willing to give up your nonbank bank?

Mr. LINTON. You betcha. You give me the heart of Glass-Steagall, as far as investment banking is concerned, and our nonbank bank, which has only to do with IRA's and Keoghs, so that our customers can keep their securities with one institution, you got it. We'll make you that deal tomorrow.

REGULATION CREATED COMPETITIVE INEQUITIES

The CHAIRMAN. Would you agree with me that there have been some competitive inequities created by Government regulation as the financial services industries have evolved, particularly the last 10 years?

Mr. LINTON. Absolutely.

The CHAIRMAN. Would you agree with me that there are only two ways to solve that—either you give the banking and depository institutions more powers or prohibit the traditional securities insurance firms, or at least require them to stay in their traditional businesses as well?

Mr. LINTON. Well——

The CHAIRMAN. Either everybody stays in their traditional line of business, or you allow this cross-mix.

All right?

Mr. LINTON. OK. And I pick A.

The CHAIRMAN. You pick to go back.

Mr. LINTON. Well, go back. I mean, I'm not talking about going back to 1933.

The CHAIRMAN. Oh, I'm not, either. But are you talking about——

Mr. LINTON. But I abhor the crossing over among these financially oriented industries that has taken place in the last decade. I

think it's been a mistake. I think it's still plenty early to do something about it.

The CHAIRMAN. Would you agree that unfair competition has been part of the very risk to the banking industry that you're worried about?

Mr. LINTON. I think that's too broad for me to agree with. I don't know what——

The CHAIRMAN. Well, it isn't any more broad——

Mr. LINTON. I really don't know what unfair uncompetition means.

The CHAIRMAN. It isn't any more broad than talking about bad management and fraud. What's the difference?

Mr. LINTON. As I say, unfair competition is pretty tough to define. So we'd have to talk that out issue by issue before I sign onto that one.

But I think——

The CHAIRMAN. No, I'm not going to let you cop out that easily. [Laughter.]

When it has traditionally been depository institutions with insurance that were in third-party checkwriting——

Mr. LINTON. OK. Well, let me answer that.

The CHAIRMAN. And then you get securities firms and you get Sears and talk about tie-ins, with real estate firms and so on. Isn't that a little bit unfair?

Mr. LINTON. You see, our checkwriting is a great client of the Bank of New York. Our checks are all drawn on the Bank of New York. They handle the entire matter, the money, the bookkeeping, and everything else. We just present a service so that our clients have got those pieces of paper to use.

And if you want that back, God bless. We'll give it to you in 2 minutes in return for a redefinition of the difference between investment and commercial banking.

The CHAIRMAN. Well, there hasn't been any change in the definition of investment. So what do you want to go back to?

Glass-Steagall has not been changed in general commerce yet.

Mr. LINTON. OK. Fine. We're not complaining about the status quo, particularly. We're concerned about some of the proposals that you make.

The CHAIRMAN. I know of nobody that advocates doing away with that provision, separating investment banking or general commerce from the banking industry at all.

Mr. LINTON. God bless again.

The CHAIRMAN. So what I hear you saying is that you are for total disinvestment, then, of all nonbank banks and all of these other services. So we put it back the way it was. Banks don't do anything else. You get back into the securities business. Jim gets back into travelers checks and credit cards. And Merrill Lynch gets back into the securities business.

We just pass a law that requires all those billions of dollars to be divested.

Is that fair?

Mr. LINTON. Well, you have a way of simplifying matters that makes it a little difficult.

The CHAIRMAN. I try to. In this body, I try to. Believe me, with all the bull that goes on [laughter]——

Mr. LINTON. If I had to go yea or nay on that, I'd go yea. Now, obviously, there are qualifications, but——

The CHAIRMAN. Well, I don't favor total disinvestment.

Mr. LINTON. Well, I don't, either.

The CHAIRMAN. I don't think that that would be fair.

Mr. LINTON. I don't, either. I don't, either. If that were the only choice, that's where I'd have to go. But it's not a black and white issue.

The CHAIRMAN. Oh, it isn't. But you sure have tried to make it on safety and soundness today.

Mr. LINTON. Yes, sir. [Laughter.]

The CHAIRMAN. But I admire you. If I were in New York, I'd have a tickertape parade for you—[laughter]—from the securities industry for your valiant defense of some of the unfair advantages you have. [Laughter.]

Senator Proxmire.

Senator PROXMIRE. Well, anything I can ask is an anticlimax compared to that. [Laughter.]

That was a masterful Garn performance. [Laughter.]

But Mr. Schreyer is having so much fun. You said you'd had a lot more fun than you thought you'd have testifying here.

Mr. SCHREYER. Well, earlier——

Senator PROXMIRE. What's that, sir?

Mr. SCHREYER. No, go ahead.

Senator PROXMIRE. OK. I just wanted to ask you one more question because it relates to Merrill Lynch.

DAYLIGHT OVERDRAFTS

As you know, only depository institutions have access to payment system mechanisms such as Fedwire and CHIPS. Banks who process payments on behalf of their customers permit overpayments in tens of billions of dollars during a day.

These so-called daylight overdrafts are settled by the end of the business day and netted out between banks. But at any point in a day, there's a substantial credit exposure. The sudden failure of a large player can bring the whole system down and precipitate a financial panic. One protection against this is through the ordinary credit judgment of the banks. A prudently managed bank would not let one of its business customers run up sizable daylight overdrafts, if it thought the company was overexposed.

Suppose, however, that the bank is owned by a large nonbanking company such as Merrill Lynch. As a captive bank, could it not be ordered into processing daylight overdrafts that were large, irrespective of normal standards of credit risk? In other words, isn't there a dangerous conflict of interest in allowing nonregulated firms, such as Merrill Lynch, to have direct access to the payment system through a captive nonbank bank?

Mr. SCHREYER. Conflict of interest?

Senator PROXMIRE. Yes, sir.

Mr. SCHREYER. I don't quite follow what that conflict—I just don't understand it. What would be the conflict of interest?

Senator PROXMIRE. Well, just causing the captive bank to process daylight overdrafts and to do so in an imprudent way.

Mr. SCHREYER. I would love to research that question and come back to you, which I will do. I just don't have the answer to that.

Senator PROXMIRE. Do you want to answer that, Mr. Robinson? It would apply to American Express too.

Mr. ROBINSON. I don't think there is one. If we're operating a separate bank subsidiary under the banking regulations and rules, why would it be any different than any other institution? You're absolutely right, that management of the bank and their directors, in the first place, provide a sense of urgency of watching what happens during the day, because there is a risk there.

Senator PROXMIRE. The point is, you have a nonregulated firm which would be making this decision, either whether it's Merrill Lynch or American Express, you're not regulated and, therefore, you would not have the same kind of restraints.

Mr. ROBINSON. As Citicorp?

Senator PROXMIRE. As Citicorp.

Mr. ROBINSON. I disagree.

Senator PROXMIRE. Well, you're not regulated under the Bank Holding Company Act.

Mr. ROBINSON. Well, it's not the Bank Holding Company Act either that provides the discipline within Citibank to deal with the issue of interday credits like.

Senator PROXMIRE. Well, I'd appreciate an answer from you, Mr. Schreyer.

Thank you very much. Thank you, Mr. Chairman. That's all.

[The following information was subsequently supplied for the record:]

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Merrill Lynch

William A. Schreyer
Chairman of the Board
and Chief Executive Officer

June 28, 1985

The Honorable William Proxmire
United States Senate
530 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Proxmire:

At the hearing before the Senate Committee on Banking, Housing and Urban Affairs on June 20th, you asked for my views on whether depository institutions that are owned by companies that are not subject to the Bank Holding Company Act of 1956 could be forced by its parent to make wire transfers that result in the creation of daylight overdrafts for the benefit of the parent.

I do not believe that a bank that is a subsidiary of such a company represents a threat to the stability of the nation's financial system. There is no evidence to support a conclusion that such a company would force its bank subsidiary to permit the creation of these improper overdrafts. I can categorically state that Merrill Lynch would not. Both Merrill Lynch's banking and securities activities are fully regulated by their respective bank and securities regulatory bodies. As such, Merrill Lynch is accustomed to operating in a highly regulated environment. As the attached analysis indicates more fully, our ownership of a bank would be consistent with the preservation of the integrity of the nation's payment system.

I appreciate the opportunity to provide you with this written response and our accompanying analysis of the issue raised by you at last week's hearing.

Sincerely yours,

/kv

ANALYSIS: PARTICIPATION IN THE NATION'S PAYMENTS SYSTEM BY BANKS WHOSE PARENTS ARE NOT SUBJECT TO THE BANK HOLDING COMPANY ACT

At the hearing before the Senate Committee on Banking, Housing and Urban Affairs on June 20th, Senator Proxmire asked whether depository institutions that are owned by companies that are not subject to the Bank Holding Company Act of 1956 represent a threat to the stability of the nation's financial system because of their ability to participate directly in the nation's payments system. The possibility was cited that a depository institution that is a subsidiary of such a company could be forced by its parent to make wire transfers that result in the creation of daylight overdrafts for the benefit of the parent. If the parent is encountering financial difficulties and does not repay the bank, the bank therefore would be unable to repay the overdraft at the end of the day. This, it is argued, could have adverse effects upon the payments system.

The ownership of a bank by a company that is not subject to the Bank Holding Company Act does not present any significant risk to the nation's payments system. Many companies that are not subject to the Bank Holding Company Act now own depository institutions that have direct access to the payments mechanism and access to Federal Reserve services. There is no evidence that any of these companies has ever attempted to force its subsidiary intentionally to create daylight overdrafts or to otherwise abuse its position. Indeed, because of the regulatory and supervisory safeguards that are in place, it is very unlikely that such an event could occur.

Depository institutions in the United States are subject to extensive examination and regulation by governmental authorities. Banks and thrift institutions are examined regularly by the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the National Credit Union Association, or the appropriate state regulatory body. As part of the regular examination process, examiners review and evaluate the institution's procedures and systems for processing large dollar funds transfers. Consequently, the examination process provides ample assurance that the situation described in the first paragraph of this analysis is unlikely to arise.

In addition, the possibility of abuse is even more remote in view of the ongoing efforts of the Federal Reserve, the New York Clearing House, and other participants in large dollar transfer systems to reduce the risks to depository institutions associated with large dollar transfer systems. Guidelines announced by the Federal Reserve Board in May ensure that transfers which are far in excess of the institution's financial capacity will not be permitted to be made. See 50 Fed. Reg. 21120 (May 22, 1985). The Federal Reserve requires that every large dollar transfer system abide by the Board's guidelines as a condition for access to the Fed's net settlement service. The Board has also proposed risk reduction guidelines for automated clearinghouse systems and U.S. government book-entry securities transfers. Accordingly, virtually all large dollar wire networks and payments systems in the country will incorporate the Board's risk reduction measures, thereby reducing further the likelihood of occurrence of abuses in the use of overdrafts.

It is incorrect to regard Merrill Lynch and others in the financial services industry as unregulated companies. Merrill Lynch & Co.'s securities and insurance activities are subject to rigorous scrutiny by a number of State and Federal regulatory authorities, as well as by self-regulatory bodies and independent auditors. Our systems, procedures and financial records are reviewed continually by these entities. In view of the extensive regulation and supervision of our affiliated companies, Merrill Lynch's ownership of a bank as a vehicle for facilitating payment system transactions is fully consistent with preserving the integrity of the payments mechanism.

The situation described above, in large measure, reflects a growing awareness among banks that depository institutions owned by companies not subject to the Bank Holding Company Act can significantly reduce expenses through access to the payments mechanism. The concern with erosion of market share was first reflected in the 1982 Report on the Payments Mechanism published by the Association of Reserve City Bankers. The importance of direct access to the payments mechanism to companies such as Merrill Lynch has been recognized by the House Subcommittee on Domestic Monetary Policy. In its 1984 report on the role of the Federal Reserve in the payments mechanism, the Subcommittee recommended that in view of the benefits that access can provide, the Federal Reserve should consider the development of specialized entities that a business can create in order to obtain access to the payments system. We believe that this is an intriguing idea that deserves additional study.

In conclusion, it appears unlikely that the situation described above will or can occur. In addition, Merrill Lynch's ownership of a bank is consistent with maintaining the safety and soundness of the nation's payments mechanism.

The CHAIRMAN. You made one remark, Mr. Linton, that the main reason you wanted a nonbank bank was just for IRA's and Keoghs.

Did I hear you correctly?

Mr. LINTON. Yes, you did. In our case, that's what they're mainly used for. Prior to that institution, our clients who might have had 1 percent or even less of their securities in an IRA or Keogh, were forced to keep those securities lodged at a bank.

In our case, it was the Delaware Trust. That was a great inconvenience. It was double bookkeeping; they had to get separate statements, and so on. Once we had a nonbank bank, then we were allowed to take those IRA's and Keogh securities into a part of Drexel Burnham Lambert and include them in one statement, and they come right out on their monthly statement, the same way as any other securities that they own.

The CHAIRMAN. I assume, being a man of great fairness and equity in wanting nonbank banks only for IRA's and Keoghs, then you would consider it fair that they have mutual fund authority just for IRA's and Keoghs for banks?

Mr. LINTON. I'd have to pass on that, Senator. I really don't understand enough about mutual funds.

The CHAIRMAN. OK.

Mr. LINTON. I wish I did. I enjoy arguing with you.

[Response to written questions of Senators Garn and Proxmire follow:]

JAMES D. ROBINSON, III
Chairman and Chief Executive Officer,
American Express Company, New York, New York

Questions for Mr. Robinson from Senator Garn - June 20, 1985

Q. The commercial loan market has been "securitized" through the development of commercial paper. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Some are starting to securitize automobile loans.

Do you agree with the forecasts of increasing "securitization" of loan markets? If so, what will this imply for the structure of financial institutions?

A. Yes, I agree with forecasts that "securitization" of loan markets will continue and increase. Moreover, I view this trend as a positive development for individual financial institutions and for the overall financial system.

For example, the advent of mortgage-backed securities has provided much needed liquidity to individual institutions. In addition, by recycling funds, this example of "securitization" has contributed to the supply of capital and credit available for housing and other purposes. The same should be true for other types of "securitized" loans.

Overall, I believe this specific development, when considered with technology and additional innovations in financing techniques and arrangements, should maximize the supply of capital for consumers and commercial organizations and strenghten and fortify financial intermediaries by providing a source of liquidity.

Q. Are "junk" or high yield bonds part of this trend - a security instrument which is a close substitute for bank loans in the middle market?

A. No, junk bonds are not in general a substitute for bank loans. In fact, junk bonds are typically subordinate to outstanding bank loans. These bonds may be considered a substitute for financings arranged through private placements with insurance companies and other institutional investors.

Finally, these bonds are not illustrative of the "securitization" trend discussed in the previous question.

Q. If this trend toward "securitization" does continue, aren't many of banks' better quality customers likely to end up with less and less of a need for a bank? If this proves to be the case - and banks are not given the right to evolve with the marketplace - won't banks become increasingly less profitable, less stable, and forced into higher risk loans?

A. As indicated above, I do not agree with the premise that the process of "securitization" will result in borrowers bypassing banks and other traditional lenders. There will always be a need and market for such lenders.

At the same time, the existence of additional sources of financing and the resulting competition which traditional lenders face may create pressures on the profitability of banks. "Securitization" allows entities other than depository institutions to originate loans. Spreads on bank loans, for example, may narrow as a result of the increased number of entrants and the intensified competition. Predictably, consumers should receive benefits in the form of reduced finance charges as the market becomes more efficient. These are positive and desirable changes from a public policy perspective.

It does not automatically follow, however, as your question suggests, that these changes will force banks to become less profitable, less stable and engage in riskier lending activities. First, banks receive tangible and important benefits from the "securitization" process. For example, origination, service and other fees will provide a sizable and steady revenue flow. Moreover, banks are relieved of substantially all credit risks attendant to making loans as principals as well as other, e.g. funding and interest rate, risks. Bank liquidity is improved. Most importantly, bank balance sheets are likely to be downsized as a result of asset sales, relieving some of the capital-raising pressures and reducing bank leverage. In short, the stability of banks should be facilitated.

Second, just as the markets are dynamic and always evolving, banks will not stand flat footed in the face of these changes. They will respond with ingenuity to the challenge of competition and take steps to maintain and expand their loan business. They will not be static. A corollary is that banks and other intermediaries should be given the "right to evolve with the marketplace" through appropriate modernization of the prevailing statutes.

Q. Is financial planning and full service implementation of financial plans for both individuals and businesses a major trend in the financial service industry?

A. Financial planning is certainly a major trend in the financial services industry. We provide a broad range of financial services and advice to individuals, corporations and governments, including planning.

For example, at Shearson Lehman Brothers, our financial consultants are trained to assist clients in defining their objectives and in selecting the most appropriate investment vehicles.

IDS Financial Services, Inc. is a leader in the financial planning field. More than 4,400 well-trained representatives offer individuals and businesses financial plans and the products and services to fulfill those plans -- investment certificates, insurance, mutual funds, annuities, etc.

In addition, AYCO, a subsidiary, counsels corporate executives with respect to financial planning.

Q. Are you in favor of complete divestiture of nonbank banks? Why or why not? Are you further in favor of redrawing lines between the financial segments? If so, what bank-like products should securities firms be required to divest? In what areas should competition be permitted to continue?

A. As I indicated in my prepared statement, I view the creation of "nonbank" banks - entities that accept deposits and make loans to individuals, but not to businesses - as a positive, pro-competitive, pro-consumer innovation. Rather than require their divestiture or subject existing nonbank banks to onerous restrictions as a condition of any grandfather treatment, Congress should act immediately to clarify their legality, specify their permissible consumer-oriented activities, and otherwise encourage their existence. "Nonbank" banks or consumer banks are alternative providers of financial services to a segment of the marketplace that is being abandoned by traditional financial institutions.

In response to the balance of the questions about "the redrawing of lines between financial segments," I submit that a return to the carefully segmented institutions of the past is both impractical and undesirable. The genie of

competition, innovation, consumer sophistication, and technology has permanently escaped from the lantern. Congress should modernize the statutes governing the discrete segments of the financial services industry to permit and encourage innovation and competition subject, of course, to essential consumer safeguards and other prerequisites of public policy.

Q. Your testimony raises fundamental questions about this Committee's whole approach to the issue before us. For example, on page 6, you say, "... the debate has been directed at the wrong questions - about defending turf, about defending specific industries or institutions by trying to create a mythical 'level playing field,' saving the very life of particular industries that have fallen on hard times."

While your ideas are excellent, some real fresh air after years of repetition, they are a little difficult to apply, generally. But, as you go on to say, depository institutions are really like utilities as a result of having deposit insurance. Unlike utilities, however, their franchise is not exclusive, as you well know.

Since American Express itself is a competitor with these "utilities," would you be willing to accept regulation of parts of your company, including audit of the interrelationships between your subsidiaries, in the name of functional regulation?

A. Yes, to serve a legitimate and necessary regulatory purpose, we would accept such regulation. In fact, we are already subject to such "audits" in many of our activities. I will elaborate because this point is essential to "functional regulation."

American Express and its subsidiaries are supervised and regulated presently and extensively under a variety of both federal and state laws and regulations which provide, in part, for regulation of the relationship between and among our subsidiaries and with the parent holding company. Specific examples include:

- American Express International Bank, an Edge Act Corporation, is directly supervised and regulated by the Federal Reserve Board.

- Boston Safe Deposit and Trust Company, a state chartered trust company, is subject to the full jurisdiction of the Federal Deposit Insurance

Corporation. As such, the FDIC examines regularly its activities, including compliance with pertinent regulations restricting its transactions with all other American Express subsidiaries.

- We are subject to extensive insurance regulation in 50 states. State insurance holding company law also regulates transactions between Firemen's Fund and other American Express subsidiaries.

As these examples illustrate, we would accept this "audit" in order to advance legitimate concerns about consumer protection and conflicts of interest. Likewise, where banks compete with securities firms, for example, we would expect the Securities and Exchange Commission, the self-regulatory organizations and state authorities to fully supervise their activities and enforce the securities laws and perform the requisite "audits" in this area. This is the essence of "functional regulation."

Q. In recognizing the blurring of traditional lines in the industrial world and recognizing that the process is an evolution - shouldn't the Congress lay the groundwork by outlining the conceptual framework of regulation by function and then permit financial institutions themselves more flexibility to evolve with the changing marketplace? Isn't the underlying purpose of deposit insurance to foster confidence in our financial intermediaries - FDIC for the banks, FSLIC for the thrifts, and SIPC for the securities firms?

A. Yes, in my prepared statement, I noted that the Administration's past legislative proposals and the Garn bill drawn from them made important conceptual headway toward "functional regulation" by using separate subsidiaries as the instrument of deregulation and diversification for depository institutions and their holding companies. This "modular" approach could be expanded to apply to diversification by all financial intermediaries as not only the fairest means to promote competition but also as the fastest because it builds upon an existing and established regulatory framework.

We don't think you can establish "functional regulation" overnight. On the other hand, we disfavor a very uneven approach whereby certain financial institutions are given powers now.

Q. What are your views on risk based deposit insurance?

A. I strongly urge Congress to reexamine the Federal deposit insurance system. Risk-based premiums are certainly one possibility. One proposal worth further exploration is tiered insurance premia with the following components and coverage: protection of depositors; protection of the banking system; excess risk fee for institutions with excessive exposure to interest rate or credit risk; and a marketing partnership fee for banks that advertise insurance coverage.

JAMES D. ROBINSON, III
Chairman and Chief Executive Officer,
American Express Company, New York, New York

Questions Submitted by Senator William Proxmire

Internationalization of Securities Markets

Last winter I asked the Securities and Exchange Commission to look into a number of issues dealing with the internationalization of the securities markets. Among the issues I highlighted were the following:

(1) Procedures for listing, disclosure and distribution of securities, particularly in relation to multinational and international issues of securities;

(2) The transition from national trading systems to global trading systems, particularly in relation to the role and appropriate regulation of United States participants;

(3) The possible design and development of a world-wide contemporaneous clearing and settlements system;

(4) The effects on trading practices of technological developments, including automation and computerization and advances in communications technology;

(5) The trend toward increased investment of the assets of pension funds in the United States in non-U.S. securities;

(6) Surveillance of global securities trading and the need for cooperative international oversight systems, exchanges of information, and international enforcement cooperation;

(7) Institutional mechanisms for international cooperation in regulating securities and related transactions, particularly in relation to the appropriate role of United States regulatory bodies, self-regulatory organizations and private entities in the emerging global system.

The Commission has begun to consider these issues.

* To what extent do you think the private sector should be involved in the study of these issues and any recommendations that might be made to Congress on this subject?

* What are your views on the importance, relevance, and timeliness of addressing this subject now?

A. As I indicated beginning on page 16 of my prepared statement, we should recognize that globalization of the financial services marketplace is inevitable. Major financial markets are becoming more closely related, more interactive and more interdependent.

I fully concur with the views expressed by New York Federal Reserve President Corrigan in a recent speech to foreign bankers that:

... "over time, there will have to be some greater convergence in thinking about financial market developments and structure among officials in the major industrial countries of the world. In the near term, greater attention and effort will have to be devoted to achieving a higher degree of coordination in cross-border supervisory efforts ... ."

Since the world is truly becoming one electronic village and global trading and global financial markets have arrived, the subjects raised in your letter to the Securities and Exchange Commission are highly important, relevant, and timely. The study of these issues by the SEC is proceeding. In addition, prominent economists, lawyers, and other experts are devoting considerable thought to the issues. Bilateral and multilateral efforts are underway to resolve some of the more immediate and identifiable problems such as enforcement of our laws in foreign jurisdictions and the linking of various trading markets. These efforts will certainly continue.

Your letter to the Securities and Exchange Commission proposed the formation of a domestic advisory commitee and, subsequently, of an international committee under American leadership. My reaction to this suggestion is favorable. It would create an excellent forum for the discussion and resolution of issues to be encountered in the process towards internationalization of the markets.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR GARN

FROM

WILLIAM A. SCHREYER
Chairman of the Board and Chief Executive Officer, Merrill Lynch & Company, Inc., New York, New York

1. Q - The commercial loan market has been "securitized" through the development of commercial paper. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Some are starting to securitize automobile loans.

   Do you agree with the forecasts of increasing "securitization" of loan markets? If so, what will this imply for the structure of financial institutions?

   A - Securitizing certain types of loans, other than commercial paper, has been a successful method of providing additional liquidity for thrift institutions and for offering high yield investments for securities investors. The market has been successful in my opinion primarily because of the government guarantees of the underlying mortgages which made the investments risk-free to the purchasers. When this concept is expanded to other types of loan portfolios, either the purchaser must assume the risk of default or some type of private insurance must be obtained. This would increase the cost and reduce the yield. It remains to be seen whether offerings of loan portfolios under these circumstances will be successful.

2. Q - Are "junk" or high yield bonds part of this trend - a security instrument which is a close substitute for bank loans in the middle market?

   A - High yield bonds are not related to this question in any manner. These bonds are merely filling a traditional function of the securities market: obtaining capital from purchasers who are willing to accept a greater degree of risk in return for a higher yield.

3. Q - If this trend toward "securitization" does continue, aren't many of banks' better quality customers likely to end up with less and less of a need for a bank? If this proves to be the case - and banks are not given the right to evolve with the marketplace - won't banks become increasingly less profitable, less stable, and forced into higher risk loans?

   A - We see little likelihood of bank customers having less need for a bank. We think it is highly unlikely that banks will

sell off their commercial loan portfolios, but even if they do, this will make their balance sheets more liquid and free up additional funds to make more loans. This would improve rather than retard profitability. Traditional bank services such as funds transfer, demand deposits and money management will still be in great demand.

4. Q - Is financial planning and full service implementation of financial plans for both individuals and businesses a major trend in the financial service industry?

A - Financial planning is a trend in financial services but it is not yet a major business and is unlikely to become one because it is appropriate for a very small percentage of the investing public. Full service financial institutions will be obliged to offer these services, but they will in my opinion, remain a very small segment of financial services as a whole.

5. Q - Are you in favor of complete divestiture of nonbank banks? Why or why not? Are you further in favor of redrawing lines between the financial segments? If so what bank-like products should securities firms be required to divest? In what areas should competition be permitted to continue?

A - We are absolutely not in favor of divestiture of nonbank banks. As I said in my testimony, limited purpose banks enable nonbank financial institutions to process more efficiently and cheaply certain types of transactions that are closely related to their major businesses. These include processing of checks and debit card transactions in connection with cash management accounts; processing movement of government securities and moving funds through the Federal Reserve payment system; and providing trust and transfer agent services to customers. There is no justification for requiring such services to be performed by banks when the result is simply to raise the cost to the ultimate user of these services, who is the consumer.

6. Q - In your statement, you say that firms have gotten into trouble because of unwise expansion into their traditional lines of business - not expansion into other fields. Do you believe that some measure of that is due to those institutions finding it increasingly difficult to maintain profitability in their traditional fields alone? If so, shouldn't Congress permit them to diversify within prudent boundaries?

A - There is no doubt that in some cases banking institutions have made excessively risky loans and gotten into difficulties as a result. It is also true that inflation and interest rate regulation made it difficult for banking institutions to maintain adequate levels of profitability. Diversification within prudent boundaries would be one way for financial institutions of all kinds to smooth out business cycles and add stable fee income. We would not oppose measures by Congress to permit prudent expansion by all financial institutions provided that equal competition and regulation by function were conditions of that expansion.

7. Q - In your view, what is the void filled by limited-purpose banks?

A - This was covered by our response to question 5.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE

FROM

WILLIAM A. SCHREYER
Chairman of the Board and Chief Executive Officer, Merrill Lynch & Company, Inc., New York, New York

Q. To what extent do you think the private sector should be involved in the study of these issues and any recommendations that might be made to Congress on this subject?

Q. What are your views on the importance, relevance, and timeliness of addressing this subject now?

Senator Proxmire also submitted questions concerning the Internationalization of Securities Markets. We believe that the private sector should be involved in the study of these issues and in recommendations that might be made to Congress. We also believe that the subject is important and timely because of the pace of development of international securities markets. The Securities and Exchange Commission, has asked for comment on many of the points which Senator Proxmire mentions. Because of the expertise and experience of the Commission, we believe that it is the most appropriate organization to study and develop proposals for the development of international trading of securities. Merrill Lynch is currently studying the releases which the Commission issued on both the Internationalization of the Securities Markets and Multinational Securities Offerings and intends to comment. We will be happy to share those comments with the Senator and with this committee.

Drexel Burnham Lambert

Robert E. Linton
Chairman of the Board

August 20, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and
Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Jake:

I am pleased to respond to your letter of July 1, 1985, enclosing questions in connection with my testimony before the Committee on June 20, 1985. Enclosed you will find my responses to your questions and those of Senator Proxmire. I appreciated the opportunity to appear before the Committee to discuss Drexel Burnham's views concerning changes in the financial services industry.

Please let me know if I can be of further assistance.

Sincerely,

Bob

REL:rf
Enclosure

Drexel Burnham Lambert Incorporated
60 Broad Street, New York, NY 10004, 212 480-7006

August 20, 1985

Responses of Robert E. Linton, Chairman,
Drexel Burnham Lambert Incorporated,
To Supplemental Questions of Senator Jake Garn
and Senator William Proxmire

Senator Garn's Questions:

1. The commercial loan market has been "securitized" through the development of commercial paper. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Some are starting to securitize automobile loans.

Do you agree with the forecasts of increasing "securitization" of loan markets? If so, what will this imply for the structure of financial institutions?

Response: I believe that the present trend toward securitization is a positive development in the financial market that will continue into the future. This trend is largely a result of the desire by depository institutions to reduce the effects of interest rate volatility on their financial performance and their desire to use their capital more effectively. The ability of a financial institution to securitize and sell off portions of its loan portfolio provides it with liquidity and the flexibility to respond to changing market conditions, with the assurance that it will be able to fund itself throughout

the interest rate cycle. Loan securitization also provides banks and thrifts with the ability to adjust their loan portfolios to better match the maturities of their loans with their available funds, thereby reducing their interest rate risk. Those loans with longer maturities that are not well suited for the institution's portfolio can then be securitized and sold-off to other lenders such as pension funds and insurance companies that can match these loans with their longer term liability structures.

By originating loans and then selling them, banks and thrifts can generate fee income that contributes to earnings and strengthens their capital positions. Since the loans do not remain on the books of the institution, the bank or thrift is able to use its available capital more effectively to originate additional loans.

2. Are "junk" or high yield bonds part of this trend - a security instrument which is a close substitute for bank loans in the middle market?

Response: High yield bonds are corporate debt issued in the form of securities. While they sometimes may be "substituted" for commercial loans, they often differ in many respects from commercial loans and can be structured to fill different needs of corporate borrowers. High

yield bonds are issued typically for periods well in excess of the maturities of ordinary bank loans. In addition, they usually carry a fixed rate of interest, while bank loans ordinarily carry a floating rate. The proceeds of high yield bonds are regarded as long term capital and are generally used to finance capital intensive projects. Because most bank loans are for shorter maturities, they are usually regarded as working capital and are used to finance transactions of a short-term or current nature. Businesses will continue to have a need for both long term and short term financing, and I believe both forms of financing will continue to grow.

3. If this trend toward "securitization" does continue, aren't many of banks' better quality customers likely to end up with less and less of a need for a bank? If this proves to be the case - and banks are not given the right to evolve with the marketplace - won't banks become increasingly less profitable, less stable, and forced into higher risk loans?

Response: The trend toward securitization of assets will undoubtedly result in changes in the way depository institutions conduct their business. More emphasis will be placed upon originating loans with the intent of subsequently selling them to third parties. As a result, an increasing proportion of an institution's income will be derived from fees related to originating, packaging,

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selling, and servicing loans than is presently the case. This does not mean, however, that depository institutions will be left with poorer quality loans. To the contrary, banks and thrifts will continue to be competitive with other credit providers. In addition, they will serve markets for borrowers whose loans are not conducive to securitization because of their special needs or characteristics. As a result of these changes, depository institutions will find themselves to be more liquid, enabling them to respond more efficiently to evolving business opportunities.

4. Is financial planning and full service implementation of financial plans for both individuals and businesses a major trend in the financial service industry?

Response: The deregulation of financial institutions and markets has led to the development of a multitude of financial products and services. Individuals, in particular, are finding it increasingly difficult to intelligently analyze the entire range of alternative investments available to them. Tax considerations have also added to the need to seek expert assistance in planning one's financial future. The growing use of IRA's, Keogh Plans and other pension and profit sharing arrangements have contributed to the need to review and consider a

broader array of financial instruments and arrangements. As a result, investors and smaller businesses are increasingly turning to financial planners to assist them in structuring well-conceived programs to help them establish their financial objectives and develop programs to achieve these goals. Although financial planning is not a major trend as of yet, I believe that it will play a more significant role in the future as today's younger generation continues to accumulate more financial resources and becomes more fully aware of the need to make arrangements for their financial future.

5. Are you in favor of complete divestiture of nonbank banks? Why or why not? Are you further in favor of redrawing lines between the financial segments? If so what bank-like products should securities firms be required to divest? In what areas should competition be permitted to continue?

Response: I am in favor of eliminating nonbank banks so long as such action is part of more comprehensive legislation to reinforce the barriers between commercial banking and the securities business. The Glass-Steagall provisions that Congress so wisely established in the 1930's to separate commercial banking from investment banking have been eroded over the years. There are many examples of the encroachment of banks into the securities business and vice versa. For example, many banks are now

engaged in placing commercial paper issued by third parties, and banks routinely offer brokerage services to the public. Securities firms are offering loans and deposit services to consumers through affiliated institutions. I believe it is time to restore and strengthen the barriers between the banking and securities industries in order to preserve public confidence in these institutions.

Because of technical reasons relating to trust law, it may be appropriate for securities firms to continue to own limited purpose trust companies that serve as fiduciaries for IRAs and Keogh Plans. Absent such affiliation, securities firms would be at a severe competitive disadvantage because they could not offer individuals a competitive retirement plan product.

6. In your testimony you argue that federal insurance represents a major competitive advantage for depository institutions.

(a) Isn't an S&L with a large percentage of its assets in high yield bonds an insured mutual fund?

(b) Should a well capitalized S&L be prohibited from investing in a diversified portfolio of high yield bonds because it would have a competitive advantage over other mutual funds?

Response: I do not believe that a deposit in an S&L is comparable to an investment in a mutual fund regardless of the composition of the S&L's portfolio. A deposit is

a debt obligation of the S&L. The deposit contract constitutes an agreement entered into in advance between the S&L and the depositor that obligates the S&L to pay a specified rate of return to the depositor in return for the depositor's agreement to leave funds on deposit for a specified period of time. A mutual fund share, however, represents an ownership interest in the fund's portfolio. As such, mutual fund investors receive a return based upon the performance of the portfolio of the fund, which may vary depending upon interest rates, defaults, and trading gains and losses. In addition, as an owner, an investor in a mutual fund often seeks capital appreciation. At the same time the investor runs the risk that he could lose a portion of his investment. A depositor, however, is a creditor of the S&L, and expects to receive his principal back at maturity.

In addition, because high yield bonds constitute only a small portion of the assets of the typical S&L, the portfolio of the average thrift institution does not in any way resemble that of a mutual fund. A recent survey of S&L's and savings banks conducted by the National Council of Savings Institutions found that 30 percent of all respondents hold high yield bonds. The survey also found that the average holdings of high yield

bonds of institutions that hold such bonds are $3.59 million. This provides confirmation that the overwhelming bulk of the industry's assets continues to be residential mortgages.

S&L's should not be prohibited or restricted further from investing in high yield bonds for several reasons. They do not have a competitive advantage over mutual funds because they do not generally invest more than a small proportion of their assets in high yield bonds. Consequently, they do not compete directly with mutual funds. In addition, a well-diversified portfolio of high yield bonds can provide S&L's with increased earnings without any undue increase in risk, while at the same time providing them with a high degree of liquidity. S&Ls need to retain this flexibility to meet changing economic conditions. For example, a substantial problem resulted in Maryland and Ohio when privately insured S&L's were unable to liquidate their real estate and other holdings to meet deposit outflows. High yield bonds held in an institution's portfolio can provide liquidity to the institution, increase its earnings and improve net worth, thereby contributing to the safety and soundness of the industry.

Senator Proxmire's Questions:

To what extent do you think the private sector should be involved in the study of the internationalization of the securities markets and any recommendations that might be made to Congress on this subject?

What are your views on the importance, relevance, and timeliness of addressing this subject now?

Response: I believe that a comprehensive study of the internationalization of the securities markets at this time would be a very worthwhile project in view of the increasing interconnections between financial markets of the world. It is essential that the securities industry participate fully and meaningfully in such a study not only because of the large stake this industry has in fostering efficient markets but also because the industry possesses the expertise that will contribute greatly to the value of such an endeavor. Drexel would be pleased to devote resources to participate in such a study.

The CHAIRMAN. Gentlemen, thank you very much for your long patience. I appreciate your coming.

STATEMENT OF ROBERT F. SHAPIRO, CHAIRMAN, BOARD OF DIRECTORS, SECURITIES INDUSTRY ASSOCIATION

The CHAIRMAN. I understand you have an airplane problem, Mr. Shapiro.

Mr. SHAPIRO. Yes, sir, but some flexibility with that as well. We needn't be completely governed by that.

The CHAIRMAN. Please proceed, and we'll see if we can get you your plane.

Mr. SHAPIRO. Mr. Chairman and members of the committee.

I am Robert F. Shapiro and appear here today as chairman of the Securities Industry Association [SIA]. In addition, I am president of Wertheim & Co., Inc., an investment banking firm.

Appearing with me today is Michael Hernandez, on my right, chairman of SIA's municipal finance committee.

I think I can probably now appreciate that there are some advantages and disadvantages to being the second panel after the dialog that just ensued. I shall try to rebut and/or clarify problems discussed earlier.

The CHAIRMAN. Knowing that you were here, you will be spared from listening to it a second time.

Mr. SHAPIRO. For nearly 10 years, SIA has been calling for a comprehensive reexamination of all the laws that have created the financial services industry as we know it today and provide for its safety through insurance, examination, and regulation. We believe the Glass-Steagall separation has produced the finest capital markets in the world and remains as valid today as it did over 50 years ago when passed by the 73d Congress.

RESTS ON TWO CORNERSTONES

A stable banking system rests on two cornerstones: confidence in the safety of deposits and lending and investment decisions that are made prudently and effectively. These cornerstones have been shaken during the past 2 years, as deposit-taking institutions careen from crisis to crisis.

In the past 2 years, as you all well know, 127 banks have failed. Almost 1,000 other banks are considered problem banks by the FDIC.

I shall not recite verbatim some of the items that I have in my prepared oral testimony, because many of the points have already been made, but I do want to refer to them, because I believe they are part of today's environment and of the record. Specifically, I refer to the troubled circumstances amongst many of our Nation's savings and loans, the Continental Illinois Bank problems are well known, and they certainly need not be amplified here once again.

We are all familiar with the foreign loans that exist and the concentration of them among some of our largest banking institutions.

In the energy and real estate areas in States such as Texas, there are clearly banks that are under more pressure today than heretofore either they have been or people had reason to expect they would be.

The farming sector problems are certainly well-known now to all of us, even if we are not part of that specific environment, and these cause concern not only for you all, I'm sure, but obviously for all of us as citizens.

In recent years, many banking institutions have shown an interest in floating privately created mortgage-backed securities, an item which has obviously been referred to extensively just prior to my participation, but I think it is important to point out that the Bank of America loan issued at least 900 million dollars' worth of securities, backed by its own mortgages, between 1977 and February 1985, yet, the Bank of America and the Wells Fargo Bank were wracked with scandal when appraisals on particular real estate properties—the ultimate collateral for the mortgage-backed securities—were found to be grossly inflated.

Bank of America was forced to take a $95 million, pretax write-off against its 1984 fourth quarter earnings. Many of these securities were sold to thrifts and other financial institutions that also sustained substantial losses.

[Response from Bank of America may be found on p. 1309.]

Mr. SHAPIRO. Let me inject here, if I might, after listening to the extensive dialog between you, Mr. Chairman, and Bob Linton, that I don't believe, and I think Bob would agree that the issue is not limited to risk. I think it is very important to what we are discussing and what we are focusing on is the structural issue, namely, how can all of our activities, and how can the system itself, which I think, unquestionably, has proved to be extraordinarily effective, both in terms of the deposit-taking and lending function, on the one hand, and the raising of capital and risk-taking function on the other hand, thus be blended so that we come up with an ongoing system that is going to serve the broadest-based needs possible?

I do think—and I know you all have been—but I want to emphasize that I believe the structural element is an equally important part of the equation, and it isn't only risk, although I don't for a moment mean to suggest that I diminish the importance of risk.

The Ohio and Maryland thrifts panics illustrate two truths, I believe, about current banking practices. First, some banks—not all—but some banks are willing to take excessive risks through the customers' deposits and at the expense of those customers and, second, the well of depositor confidence may well be running dry.

Today, banking environment is fraught with risk, and granting banks additional securities powers, in our view, will not lessen their exposure.

Will the bank entry into the securities industry improve competition? This is an important consideration. In the short term, possibly, since loss leader pricing may be used by bankers to gain market share. But in the long run, the securities industry, I do not believe, can be more competitive than it is today.

Since 1975, the securities industry has serviced markets that have grown broader and deeper. In 1975, the New York Stock Exchange average trading volume was 18.6 million shares a day, and last year, it was 91.1 million, an almost fivefold increase.

CAPITAL BASE OF $16.8 BILLION

Even more dramatic increases have occurred on the American Stock Exchange and in the over-the-counter markets. Meeting this expanded investor need has met a dramatic expansion of our members capital base. In 1975, the industry capital was approximately $1.7 billion. Today, our capital base is $16.8 billion and expanding rapidly to meet investors needs.

Meeting the capital needs of corporate America is a job we have done well and continue to do well, and of which we are proud.

Last year, we raised $82 billion in new debt and equity capital, and almost $4 billion of that total was for corporations coming into the markets for the first time.

Finally, it must be noted that ours is an industry of risk with dramatic swings in profitability. It seems obvious that permitting bank entry into the securities business will only increase volatility, thereby undermining the public's confidence in bank stability, a critical factor in today's environment.

The idea of granting banks additional securities powers, provided such activities are carried on in a separate securities affiliate of a bank holding company was first advanced by Secretary Regan in testimony before this committee in 1981. The presumed advantage of a separate securities affiliate are twofold: To protect the safety and soundness of the bank and the banking system and to provide an environment in which bank securities affiliates and other securities firms can compete on fair and equal terms.

We are frankly skeptical that either objective can be fulfilled.

The first objective assumes that a bank could allow a securities affiliate to fail without attempting its rescue or that such a failure could occur without substantial consequential harm to the affiliated bank. Mr. Walter Wriston, chairman of Citicorp, shared his skepticism with you in testimony before the committee on October 29, 1981, and indeed, just a short while ago, we heard several of the other gentlemen basically corroborate this concept.

The second objective providing a fair field of competition between bank securities affiliates and securities firms cannot be achieved without prohibition of flow of capital and business relationships to the affiliate.

The conflict of interest question is part of all we do and whatever sphere of activities in which we operate and I don't think, as indeed was mentioned earlier, I think by Senator Dodd, that that is an issue that can or should be overlooked. I think it is directly relevant to the questions that we are addressing here this morning and which you just pointed out you have been addressing for many years.

SIA is aware of the current blurring of some traditional lines between financial intermediaries. The association also recognizes the concerns of Congress and the American people for a safe, sound, and economically viable banking sector that protects savers and provides a stable base of objective credit while other sectors help facilitate investment and help ensure the greatest possible access to capital.

The American system of separating the investment and commercial banking functions has proven spectacularly productive. No

doubt, much of the current confusion concerning the roles of commercial banking and securities industries arises from the innovations each sphere has made in the delivery of a wide range of services to its customers.

SIA believes that the elimination of Glass-Steagall Act separation would not bring with it the benefits claimed by large money center banks. Eliminating the act would result in inadequate customer protection, increased concentration of financial power, and a movement toward European-style universal banking with its bias against entrepreneurialism.

SIA believes that after a thorough review of the facts and the relevant laws, Congress will decide to strengthen, not weaken, Glass-Steagall protections.

Thank you, sir.

[The complete prepared statement and response to written questions of Senator Mattingly follow:]

TESTIMONY OF SECURITIES INDUSTRY ASSOCIATION

Presented By

Robert F. Shapiro

Chairman of the Board of Directors

On Financial Industry Oversight

Introduction

Mr. Chairman and members of the Committee, I am Robert F. Shapiro and appear here today as Chairman of the Securities Industry Association ("SIA"). In addition to my duties as Chairman of SIA, I am President of Wertheim & Co., Inc., an investment banking firm. My 28 years in the investment banking industry has created a healthy respect for the risk we take daily, and for the obligations we have to investors and corporate America. Appearing with me today is Michael Hernandez, Manager of Public Finance, Kidder Peabody & Co. Incorporated, Chairman of SIA's Municipal Finance Committee.

SIA is a national trade association representing more than 500 organizations responsible for the vast majority of the securities brokerage and investment banking business of the nation. The business of our members includes retail and institutional brokerage, over-the-counter market-making, underwriting and other investment banking activities, and various exchange floor activities. The size of our member firms, whether measured in terms of net capital, number of account executives or offices, ranges from the very largest wire houses serving the entire country to small local firms. On behalf of that entire membership I express appreciation for the opportunity to appear before your distinguished Committee today.

SIA shares your concerns as to the direction and efficacy of the changes being wrought by clever lawyers and equally clever financial institutions. These changes seem to go forward without

consumer demand and counter to the entrepreneurial spirit found in our population.

Our industry advises corporate America on possible mergers and acquisitions and, needless to say, today we are assisting many conglomerates in divesting unwanted or unprofitable subsidiaries and affiliates. Big isn't necessarily better, and diversification doesn't necessarily mean higher profits. But caution must be the byword with financial institutions because a mistake shakes public confidence in our depository institution both here and abroad.

For nearly ten years, SIA has been calling for a total reexamination of all the laws that have created the financial services industry as we know it today, and provide for its safety through insurance, examination and regulation.

Only two weeks ago our Executive Committee once again discussed the Association's position on many of the issues facing this committee, and again unanimously endorsed the current separation between commercial and investment banking.

SIA hopes that your committee and the Congress will agree that this separation has produced the finest capital markets in the world. If you do, then your focus shall be on closing loopholes in the Glass-Steagall Act for thrifts and state non-member banks, and closing loopholes in the Bank Holding Company Act. Rationalizing the deposit insurance system, regulatory reform, and sensible rules regulating the brokering of deposits need to be addressed.

Banking Industry Problems

A stable banking system rests on two cornerstones: Confidence in the safety of deposits, and lending and investment decisions be

made prudently and objectively. These cornerstones have been badly shaken during the past two years as deposit taking institutions careen from crisis to crisis.

Bank Failures

In the past two years, 127 banks have failed. The most recent two year period has witnessed the greatest number of bank failures since the Great Depression. Almost 1,000 other banks are considered "problem banks" by the FDIC.

In addition to banks, many of the nation's thrift institutions also are in danger. Edwin T. Gray, chairman of both the Federal Savings and Loans Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (FHLBB), told a House Subcommittee that up to 10 percent of the nation's savings and loans are in "severe trouble" and that between 250 and 300 S&Ls are on the FHLBB's "trouble list." More startling, he said that "even tripling insurance premiums to boost the FSLIC fund by $1 billion would be insufficient to cover expected failures."

Continental Illinois National Bank Failure

In May of 1984, Continental Illinois National Bank -- the nation's eighth largest -- almost failed, due in part to bad energy loans. What prevented total collapse was an unprecedented $4.5 billion rescue package of the holding company put together by federal bank regulators. The New York Times succinctly conveyed the message of this act: "The Government will step in with Federal money, backed by the power of the Federal Reserve rather than allow a big bank to fail...." Former Treasury Secretary Donald T. Regan said at the time, "we will make sure that there are no calamities in the banking system." No other competitor has

this assurance of a massive federal safety net to subsidize its bad judgment in the securities marketplace.

Foreign Loan Crisis

U. S. banks have approximately $100 billion at stake in loans to foreign banks, including $26.3 billion to Mexico, $20.7 billion to Brazil, $11.3 billion to Venezuela, and $8.5 billion to Argentina. Many of these loans are held by just a few of the nation's big banks. For example, Manufacturers Hanover Trust alone holds $1.3 billion in Argentina's debts. An outright default by Argentina would wipe out 40% of the bank's equity capital.

Every few months, a foreign debt crisis looms, and some arrangement is made to defer current interest due, to reschedule loans, or to obtain International Monetary Fund credit. This continuing saga was described by Newsweek as a "soap opera," in which "it doesn't seem to matter when you tune in on the debt crisis -- all the basic problems remain the same."

Energy Related Problems

In Texas, depressed oil prices and a glutted real estate market have had a dramatic impact. The Wall Street Journal reports that "just three years after energy lending turned into the biggest bust since the Great Depression, a second wave of financial problems is rocking big Texas energy lenders, portending more serious losses at even the strongest banks."

The seriousness of these banks' problems is illustrated by the crackdown by federal regulators in requiring the banks to adopt more conservative accounting practices and more stringent criteria for evaluating loan collateral. Examiners of the Comptroller of

the Currency have pitched their tents in Houston and Dallas to examine energy lending by Texas banks.

Farm Bank Crises

The financial plight of America's family-owned farms is testing depositor confidence as well. Of the nation's 15 banks that failed during the first two months of 1985, more than half were "farm banks" -- those 4,000 plus institutions which do more than 25% of their lending to the farm industry. Additional casualties are expected.

Dangers of Securities-Related Lending

In the midst of this widespread failure, the expansion of bank powers is both implausible and irresponsible. The conflicts of interest that arise when banks engage in securities-related ventures severely undermine a bank's ability to continue making disinterested banking decisions.

As an example, at the height of activity in real estate investment trusts (REITs) in the early 1970s, it was a common bank practice to extend loans to a REIT which also received investment advisory services and sponsorship from the bank or its affiliate. Indeed, the losses suffered by Chase Manhattan Bank, N.A. during the 1970s in the protracted decline and ultimate collapse of the REIT, which only bore its name, painfully demonstrated how such conflicts help put the nation's third largest bank on the "problem bank" list of the Comptroller of the Currency.

Underwriting Problems

In recent years, many banking institutions have shown interest in floating privately created mortgage-backed securities. Bank of America alone, for example, issued at least $900 million worth of

securities backed by its own mortgages between 1977 and February 1985. Yet, Bank of America and Wells Fargo Bank were racked with scandal when appraisals on particular real estate properties -- the ultimate collateral for the mortgage-backed securities -- were found to be grossly inflated. Bank of America was forced to buy back securities it had issued for $133 million. Their value was close to $38 million. This forced Bank of America to take a $95 million pre-tax write off against its 1984 fourth quarter earnings. Many of these securities were sold to thrifts and other financial institutions that also sustained substantial losses.

The dangers of securities-related lending and underwriting are not limited to mortgage-backed securities or REITs. Should an issuer for whom a bank has effected a private placement, for example, find itself in unexpected financial difficulty, the bank may feel obliged to extend a loan which otherwise might not conform to its normal credit standards. By doing so, it would seek to avoid the understandable embarrassment and damage to its reputation among institutions that had purchased the offering, or the possibility of litigation under the securities laws.

Banks involved in an unsuccessful sale of commercial paper, to cite another example, would be forced for competitive reasons to make a loan in the amount of paper unable to be placed. This could result in an allocation of the bank's assets to issuers whose credit is the most difficult to place, i.e., those whose paper is least acceptable to buyers of commercial paper. Currently, three large banks are engaged in the sale of commercial paper, although the legal status of this activity remains to be decided in the courts.

The Ohio Thrift Crisis

The photographs of depositors lined up outside Ohio savings and loan associations in the spring of 1985 are a vivid reminder that bank runs did not end in the 1930s. The crisis was brought about by thrifts which had risked their depositors' money in the government securities market. Using repurchase agreements to seek higher returns and to skirt loan limits, the thrifts were besieged after the failure of a small, unregulated dealer, E.S.M. Securities, in March 1985. The collapse brought down Cincinnati's Home State Savings Bank, a $150 million E.S.M. investor. Panic then spread throughout Ohio, as Home State's failure threatened to exhaust the state's $130 million private insurance fund, which covers deposits at 70 of Ohio's nearly 300 savings and loans. More than 1,000 people camped overnight in front of these S&Ls, hoping to claim their money before it was gone.

Ohio Governor Richard Celeste ordered all privately insured thrifts in the state to close -- the most widespread financial shutdown since President Roosevelt declared a one-week national bank holiday in 1933. Although the immediate danger of a wider panic subsided in a few days, the uneasiness in Ohio rattled savers across the nation and worried foreign investors as well. Time magazine reported that "in a classic sign of anxiety," the price of gold shot up by $35.70 in one day at the height of the panic. "At the same time," Time reports, "a rocketing dollar took a nose dive as traders fretted about the stability of the U. S. banking system and the strength of the economy."

The Ohio scenario was repeated just two months later in Maryland, where a thrift whose problems touched off the crisis had

been charged with numerous violations of state banking regulations. Old Court Savings and Loan had millions of dollars in unsecured overdrawn accounts to officers and directors, and millions more in loans on properties in which it also held an interest. Again, federal insurance was the ultimate rescuer for depositors. As The Washington Post editorialized on March 19, 1985:

> High interest rates, and the deregulation of the interest rates that banks and S&Ls can pay their depositors, have turned consumer finance into a game of substantial risk and extraordinary complexity...The sad story of the Ohio S&Ls is another warning that any future deregulation of the financial institutions needs to be approached with extreme caution -- and in some areas re-regulation is worth considering.

The Ohio and Maryland panics illustrate two truths about current banking practices: first, some banks are willing to take excessive risks with their customers' deposit and at the expense of their customers (who must then be bailed out by insurers); and, second, the well of depositor confidence may be running dry.

Given the ample evidence that today's banking environment is fraught with risk, it would be foolhardy to suggest, as many money-center banks do, that granting banks additional powers in the securities industry would somehow lessen their exposure. Moreover, permitting banks to expand into areas of general commerce calls into question their very uniqueness. As the Federal Reserve Bank of Minneapolis said in its 1982 annual report: "If anything, concerns regarding financial concentration, conflicts of interest, and the fiduciary responsibilities associated with lending depositors' money may be more relevant today than they were 50 years ago."

Economic Arguments

Will bank entry into the securities industry improve competition? In the short-term, since underpricing will be used by bankers to gain market share, possibly, but in the long run the securities industry cannot be more competitive than today.

Let's examine the facts, and start with the simple fact in 1975 the securities industry was deregulated as to commissions, and with price deregulation being completed by the adoption of SEC Rule 415 in 1982.

Since price deregulation in 1975, our industry has grown from 2,893 registered broker/dealers to 5,726 in 1984. One must remember, anyone but a bank with $5,000 and an application can become a broker/dealer. Price and geographic deregulation is only beginning in the banking and thrift industries, and both are shrinking rapidly.

Since 1975 the securities industry has serviced markets that have grown broader and deeper. In 1975 NYSE average daily trading volume was 18.6 million and last year it was 91.1, an almost 5 fold increase. During the same time frame, the price per share increased by almost $8.00 per share. Even more dramatic increases have occurred in the AMEX and OTC markets. Listed options didn't exist in 1975, and today comprise a market where 87 million contracts traded last year, and that's down from almost 100 million in 1983.

Meeting this expanding investor need has meant dramatic expansion of our members' capital base. In 1975 the industry capital was approximately 1.7 billion dollars. Today our capital

base is $16.8 billion and expanding rapidly to meet investors' needs.

Meeting the capital needs of corporate America is a job we have done well, and continue to do well. Last year we raised for them $82 billion in new debt and equity capital, in 1984 corporate short-term funding in the form of commercial paper was handled by our industry in an amount estimated to exceed 300 billion dollars, and municipal issuer raised 136 billion dollars, with the securities industry underwriting 89 percent of that total.

Additionally, we must note that our industry raised almost 4 billion dollars in capital for corporations coming to the market for the first time. Three times that amount was raised in 1983. 1984 was another banner year for raising venture capital. We estimate it at $3.2 billion, up from $2 billion in 1983.

Finally, it must be noted that ours is an industry of risk with dramatic swings in profitability, as the following chart demonstrates.

RETURN ON EQUITY
ALL SECURITIES FIRMS

Year	1Q	2Q	3Q	4Q
1979	14.5	17.00	19.2	13.1
1980	14.3	39.1	22.7	29.4
1981	26.0	23.2	8.0	21.1
1982	5.5	9.1	28.5	41.3
1983	29.9	31.2	14.8	6.0
1984	9.2	(1.8)	12.5	8.7

The opposite is true of the banking industry.

RETURN ON EQUITY
FDIC COMMERCIAL BANKS

Year	1st Half	2nd Half
1979	15.6	12.2
1980	17.2	13.1
1981	13.9	12.2
1982	12.6	11.6
1983	12.5	9.3
1984	9.5	9.9

It seems obvious that permitting bank entry to the securities business will only increase earnings volatility, thereby undermining the public's confidence in bank stability, a critical factor in today's environment.

The Separate Subsidiary Concept

The idea of granting banks additional securities powers, provided such activities are carried on in a separate securities affiliate of a bank holding company into which the affiliated bank would have to transfer its presently authorized underwriting activities, was first advanced by Secretary Regan in testimony before this Committee on October 19, 1981.

The SIA gave a qualified endorsement to the concept of a separate subsidiary in 1981, but only if the Congress decided to grant additional securities powers to banks. At the risk of being repetitious, we repeat our view that it is contrary to the public interest to grant such additional powers to banks. However, the

separate subsidiary approach is a preferred alternative to having the securities activities conducted in the bank.

When the SIA testified February 12, 1982, before this Committee's Subcommittee on Securities we analyzed the concept of a separate securities affiliate and what principles should be followed and enacted into law that would create a fair competitive environment and proper insulation of the securities activities from the bank holding company complex. Those concepts are as valid today as they were when written 3 years ago.

The presumed advantages of a separate securities affiliate are two-fold -- to protect the safety and soundness of the bank and the banking system and to provide an environment in which bank securities affiliates and other securities firms can compete on fair and equal terms. We are skeptical that either objective can be fulfilled.

Failure to Protect Bank Safety and Soundness

The first objective assumes that a bank could allow a securities affiliate to fail without attempting its rescue, or that such a failure could occur without substantial consequential harm to the affiliated bank. Mr. Walter Wriston, Chairman of Citicorp, shares our skepticism. Commenting on the concept of a separate securities affiliate in testimony before your Committee on October 29, 1981, he stated:

> A holding company is probably the clumsiest, most expensive way that exists to operate any business. We have only gone to a holding company in order to comply with the law, and gain some flexibility by so doing. But it is a very poor way to operate. For example, it is inconceivable that any major bank would walk away from any subsidiary of its holding company. If your name is on the door, all of your capital funds are going to be behind it in the real world. Lawyers can say you have separation, but the marketplace is persuasive, and it would not see it that way.

> So I don't see any benefit in getting a separate subsidiary for new businesses...I don't see any benefit from it myself.
>
> I would go just the other way. If the National Bank Act was amended to say that everything a bank holding company can do, the National Bank can do, I'd be extremely happy. It would simplify administration and would make it perfectly clear to the customer that our $7 billion capital is behind everything that we do. (Emphasis supplied.)

Unfair Bank Advantages

The second objective of providing a fair field of competition between bank securities affiliates and securities firms, cannot be achieved without prohibition of the flow of capital and business relationships to the affiliate.

Non-banking entities facing competition from bank affiliates in nonbanking areas have real cause for concern that the affiliates would enjoy an unfair competitive advantage. Banks can and do extend credit to their affiliates in amounts and on terms that other firms could never secure. To reassure Congress and regulators that nonbank affiliates would not enjoy an unfair advantage, bankers frequently cite Section 23A of the Federal Reserve Act, which generally is intended to require adequate collateralization of loans by member banks to their affiliates. But Section 23A, which was "liberalized" by the "Banking Affiliates Act of 1982," is hardly even a mild restraint on bank loans to affiliates.

First, transactions between a bank and its majority-owned non-bank subsidiaries are not even "covered transactions" subject to Section 23A. Second, many transactions that otherwise would be "covered transactions" are expressly exempted; for example, a bank loan to an affiliate that is fully secured by U. S. Government

obligations. Third, the quantitative limitations on covered transactions -- 10% of a bank's capital stock and surplus on credits to any single affiliate and 20% on credits to all affiliates -- are far from onerous.

A few current examples drive this point home. Based on their respective 1984 annual reports, a major New York bank had authority under Section 23A to lend $278,880,000 in covered transactions with affiliates, while a major California bank had authority to lend $434,618,400.

It must be noted as well that Section 23A does not in any way restrict loans by a bank holding company to its nonbank subsidiaries of funds derived from dividends of its banking subsidiary, nor does it regulate interest charges on covered transactions.

In short, the mere fact that a loan to a nonbanking affiliate may be adequately collateralized, or funded by bank dividends, is little comfort to a competitor of the affiliate. Section 23A may reduce the risk of a bank failure, but it does not redress the inequity of bank affiliates having access to loans on preferential terms: sometimes it is whether you can get the funds, not their cost, which is the critical consideration.

Also, "tie-ins" are becoming more of a difficult unfair bank advantage in the underwriting of bank-eligible municipal revenue bonds. The number of issues utilizing letters of credit or other credit enhancements has escalated sharply in recent years. Banks have an unfair advantage when they or their affiliates can underwrite securities for which they supply credit facilities. A credit facility is often the difference between a deal and no

deal. Even Federal Reserve Board Chairman Volcker recognizes this problem of unfair bank competition. In testifying about what should be prohibited in any bank and securities affiliate structure, he proposed that banks be prohibited from guaranteeing or providing letters of credit to support obligations or mortgage pools underwritten by a securities affiliate of that bank. The law should be amended now to prohibit banks themselves from underwriting obligations or mortgage pools for which they provide credit facilities.

Finally it must be noted that, in addition to inherent cost tax advantages, the banks' permissive regulatory structure and their unique customer relationships would give bank securities affiliated unparalleled competitive advantages which cannot neutralized by the securities affiliate structure.

Conclusion

SIA is aware of the current blurring of some traditional lines between financial intermediaries. The Association also recognizes the concerns of Congress and the American people for a safe, sound, and economically viable banking sector that protects savers and provides a stable base of objective credits which other sectors help facilitate investment and ensure the greatest possible access to capital. The American system of separating the investment and commercial banking functions has proven spectacularly productive. No doubt, much of the current confusion concerning the roles of the commercial banking and securities industries arises from the innovations each sphere has made in the delivery of a wide range of services to its customers. But elimination of that separation would be a mistake of enormous consequences.

The elimination of the Glass-Steagall Act would not bring with it the benefits claimed by large money-center banks. Eliminating the Act would result in inadequate customer protection, increased concentration of financial power and a movement toward European-style universal banking, with its bias against entrepreneurship. SIA believes that, after a thorough review of the facts and the relevant laws, Congress will decide to strengthen, not weaken, Glass-Steagall protections.

As the Washington Post editorialized on March 28, 1985, "If a banker decides that he wants to go for the big money in real estate development or securities underwriting, he has every right to do it, but perhaps he ought to be asked to get out of commercial banking first." (Emphasis added.)

Question from Senator Mattingly to Michael D. Hernandez, Chairman of the Municipal Finance Committee of SIA, accompanying Robert F. Shapiro, Chairman of SIA, testifying before the Senate Banking Committee, June 20, 1985:

Mr. Hernandez, I hear a lot said about the unfair advantages that banks and banking organizations have when they seek to compete outside the field of banking where, admittedly, for the soundness of the banking system they have been given and enjoy certain benefits. Could you give me some specifics of what you are talking about?

Answer: Certainly, Senator. First, let me say that any contest between a bank and a non-bank is inherently anticompetitive. A bank's special advantages - provided to perform its special role as a bank - are unfair and destructive of effective competition when used outside the field of banking. This fact has been recognized by the Congress in enacting the National Banking Act of 1864, the Glass-Steagall Act and the Bank Holding Company Act, all of which confine the range of commercial banking activity.

The key difference between a bank and any competitor is a bank's ability to take deposits to use in its own business - federally insured deposits at that - resulting in readily available and inevitably lower cost capital for all of its endeavors. Of course, they also have their captive markets, e.g., their investment portfolios, their trust departments, their pension funds and their correspondent banking relationships. Of increasing importance today is their ability to tie the extension of credit to other services which they offer, which in some cases can include underwriting.

Banks, as the ultimate suppliers of credit in our economy, have leverage that no other institutions have. There has been a tremendous growth in variable rate financings in the tax exempt market in recent years. The growth started when high inflation and high interest rates hit the single family mortgage revenue bond market in the late 1970s and the early 1980s. Economic conditions had pushed mortgage rates, even those funded by tax exempt bonds, to unaffordable levels. To bring those rates down, a new financing device, the "put bond," was developed. To make the put bond work, a letter or line of credit was essential.

In 1982 before the Subcommittee on Securities of this Committee SIA presented the results of some original research which showed that the use of letters of credit in underwritings was on the increase and that some banks appeared to have unfairly taken advantage or benefitted from the unfair advantage of their positions as credit suppliers to leverage themselves into management positions in underwriting groups for

bank-eligible revenue bonds. SIA tracked three major banks for 1981 and found that in every one of the 24 mortgage bond issues in which one of them served as a manager that bank had offered a letter of credit or other credit enhancement: 24 out of 24. Amazing coincidence. (Hearings before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate (97th Congress, Second Session) on S. 1720 [Report 97-47, pp. 438-466, esp. 457-466; also see pp. 138-139])

SIA pointed out that banks had not been very successful in selling themselves as managers on an even competitive basis in earlier years when credit enhancements were not significant. However, particularly in times of high interest, the unique ability of banks to provide letters of credit gave them the unfair advantage of being able to offer a LOC to obtain a place in a management group. SIA argued then that existing tying restrictions in the law were inadequate to deal with these unfair situations, because no large, sophisticated bank was dumb enough to demand a quid pro quo, but the pressure and unfair advantage were nonetheless there.

Letter of credit (LOC) volume in 1980 was only $100 million, but grew to $4.7 billion in 1981. The letter of credit support spread to other revenue bond sectors and in 1984 letters of credit were found in 374 issues aggregating $13.9 billion.

SIA decided to track the same three banks again and did so for 1984, the most recent year for which statistics are available. This time all bank-eligible revenue bond sectors were looked at and the findings were that the three banks supplied letters of credit in 28 of the 36 issues as to which they served as underwriting managers--78%. Quite a record.

It is clear that the LOC is an incredibly valuable and unique tool for a bank to use to get itself into a management group. This is true whether the bank is underwriting as well as providing the letter of credit or whether the underwriting is being done by an affiliated securities affiliate.

This is a very real example of unfair bank advantage that is growing in the bank-eligible revenue bond market today. I do not mean to suggest that these three banks are alone. Other banks are now doing the same thing in increasing numbers. Just as the link between federal deposit insurance and federal credit backup supplied by the Federal Reserve System and speculative and unwise activities of banks is not broken by the establishment of a separate holding company subsidiary (witness

the rescue of the Continental Illinois holding company complex) the leverage of bank credit is not lost to a securities affiliate. Last year's S. 2851 did not deal with the problem and statements that existing antitrust laws are sufficient are just not well founded..

I have a brief summary of the most recent study results to present at this time:

Summary
1984

Security Pacific:

Supplied letter of credit for 18 of the 19 issues for which it acted as a manager. (In the 19th, Citibank supplied the letter of credit for a Security Pacific client for which Security Pacific had three times that year already provided the LOC and acted as a manager.)

Citibank:

Supplied letter of credit for six of the nine issues for which it acted as a manager.

Chemical:

Supplied letter of credit for four of the eight issues for which it acted as a manager. (In one of the other deals Citibank supplied the LOC.)

Question: Banks assert that if they are able to underwrite in areas precluded to them competition will increase and costs will decrease. What is your response to this argument?

Answer: The assertion that municipal bond issuers would save money if the Glass-Steagall Act were amended to permit commercial banks to underwrite presently ineligible revenue bonds has been analyzed in numerous congressional hearings since 1963 and consistently refuted. The most exhaustive analysis of the claimed savings occurred during lengthy hearings before the House Subcommittee on Financial Institutions Supervision, Regulation and Insurance in 1979. Those hearings focused on a statistical study conducted by Professor Phillip Cagan (and sponsored by the Dealer Bank Association) which estimated that the present value of interest

savings for ineligible revenue bonds issued in 1977 would have been $412 million, and the responses thereto, prepared at the request of the SIA, and presented by Professor Michael Mussa, University of Chicago, and Professor George G. Kaufman, Loyola University of Chicago.

The main conclusions of the studies of Mussa and Kaufman are that:

- bank eligibility has had no statistically significant effect on the interest costs of negotiated revenue issues;

- bank eligibility has had no direct statistically significant effect on the interest costs of competitively sold revenue issues;

- there is no reliable or convincing statistical evidence that bank eligibility has increased the number of bids on revenue bonds sold competitively; and

- there is no statistical evidence that interest yields on eligible bonds have behaved differently than yields on ineligible bonds as the bonds move from the primary market to secondary market.

In sum, no convincing statistical evidence was found to support the claim that permitting commercial banks to underwrite municipal revenue bonds would result in any cost savings to issuers. It is clear from the Mussa and Kaufman studies that comparable bank eligible and bank ineligible bonds sell at statistically indistinguishable interest rates. These two studies have been made available to all, including government agencies, and, to the best of my knowledge, no one has found any errors in either the statistical analysis or in the conclusions.

Since the publication of the critiques by Mussa and Kaufman of the Cagan study, the Dealer Bank Association has abandoned its reliance thereon in favor of a new study of interest savings written by Professor William Silber. The Silber study, however, does not present any new factual evidence of statistical results; it simply reviews the results of other studies written prior to October, 1979. The Silber study was also convincingly refuted by Mussa during hearings before the House Banking Committee in October 1981.

Banks have always been able to underwrite the general obligation bonds of state and local governments, there being a specific exception to the Glass-Steagall Act permitting such activity. Banks can claim a great level of expertise in such underwritings and of course state that their presence in that market leads to a greater number of bids. However, more and more states and municipalities are now choosing to select a team of underwriters to negotiate the sale of their general obligation bonds. In fact, the volume of negotiated general obligation bonds has grown from $1.2 billion in 1981 to $7.2 billion in 1984--a rate of growth faster than for any other area of municipal financing. This trend certainly undercuts bank arguments that negotiated revenue bond underwritings would be less if they could underwrite all revenue bonds. Also, it is interesting to note that the vast majority of municipalities selecting underwriters for their negotiated general bond underwritings are choosing investment bankers and not commercial bankers--except where a letter of credit is involved. It does not appear that municipalities view banks as adding to competition or as providing a better service at a lower price.

Question: Why is not this a good time for banks to get new powers in the securities business? They say they need the fee income to survive in a changing world.

Answer: Ours is a risky business. I do not say that commercial banking does not have its risks. Of course it does. And Congress has decided that the core activities of a bank are so essential to the economy that the United States government is going to stand behind a bank, at least a large one, to insure the stability of the banking system. I think that is good for all of us, but that does not mean that I want a federally-backed institution as a competitor. That is unfair competition and allowing banks to participate more broadly in the underwriting business would change the character of the risks which banks should be taking. The Supreme Court said it well in Investment Company Institute v. Camp:

> "In sum, Congress acted to keep commercial banks out of the investment banking business largely because it believed that the promotional incentives of investment banking and the investment bankers' pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system. As Senator

> Bulkley put it: 'If we want banking services to be strictly banking services, without the expectation of additional profits in selling something to customers, we must keep the banks out of the investment security business.'" 401 U.S. 617 634

A revenue bond is not like a general obligation bond. It is not backed by the taxing power of any sovereign. It is an enterprise security, much more like a corporate bond or a mortgage-backed security or any other asset or revenue based security, which often needs external support, such as a letter of credit.

I should point out also that many well-managed banks are reporting profits of historic proportions. The questions involved are much, much more complicated and far-reaching that how much fee income a bank needs. Our financial system has worked incredibly well for decades and in my view the Glass-Steagall Act has been a major contributor to the vitality and diversity of our system. It works better than any other in the world. Before any fundamental changes are made to it--and the proposals to plunge banks back into the non-tax supported securities market certainly would do that--Congress owes it to the nation to perform a careful and thorough examination of how our system works, how it can be improved and what is needed for the next 50 years. If that is done, we are confident that the separation of banking from commerce and investment banking from investment from commercial banking, will be continued if not strengthened. Diversity, market dynamism and freedom from concentration of financial resources are advantages not to be thoughtlessly tossed aside.

51-337 O—85——35

The CHAIRMAN. Mr. Silver, if it's all right with you we'll go ahead and ask Mr. Shapiro his questions and maybe he can make his airplane, unless you also have a time problem.

Mr. SILVER. No, sir. Go right ahead.

The CHAIRMAN. I doubt it if you were catching an airplane.

Mr. SHAPIRO. Senator, I can probably make one at 2 o'clock also. I don't want to in any way impose on Mr. Silver's opportunity to express himself here this morning.

The CHAIRMAN. Oh, no, he'll get his opportunity. Dave and I have had our discussions for many, many years.

Your testimony once again highlights the problems of banks, but it gets back to this double standard again. Haven't many of your members created deposit-taking nonbank banks, most of which would be grandfathered under the House bill that was passed last week?

SIA IS IN A DEPOSITMAKING MODE

Mr. SHAPIRO. I don't believe that our industry—in fact, it is in a depositmaking mode. It is certainly so that there has been collaboration between securities firms and commercial banks whereby securities firms have directed flows of moneys to commercial banks.

Merrill Lynch, obviously, is through its CMA account and bank 1. But we are not, as you well know, an industry that is permitted to take deposits guaranteed by Federal insurance and, as you well know also, we do not make loans. So I think that's a fundamental distinction between what we do and what the commercial banking industry does is still very much valid.

The CHAIRMAN. Well, you know, the nonbank bank loopholes—don't play games with me over a legal definition. It is competition, whether it is exactly the same or not, it is competition. That's the thing that has frustrated me and caused the major bone of contention between me and the securities industry—the unwillingness to come in and just be honest about it and say, hey, we want to do this and we are going to try to do it and don't let the banks come in. That's fine. I understand that kind of directness and I have never been known for playing games with anybody, and that's why I appreciate the few witnesses in the insurance business yesterday and a couple here today who will essentially say that.

But you really insult my intelligence when you come in with the safety and soundness issue and play holier than thou with motherhood and say, keep those guys out but for Lord's sake don't touch us as we try to get into the banking business.

All I'm trying to get people to do is to be honest about what they're doing. Everybody knows it. It's like the covert aid in Nicargua. It isn't covert. Why do we call it covert? Why don't we just help the Contras openly and above board and why can't the securities industry admit that they're getting into the banking business?

Mr. SHAPIRO. Well, as you know, Mr. Chairman, the securities industry is not monolithic. In fact, as most recent years have passed it has become a very diverse industry in terms of who does what to whom. Our firm, for example, does not have a nonbank bank. As a matter of fact, we don't even choose to have one. That's not the

basic business in which we are engaged nor, for our purposes, do we believe it is what it should be.

For the most part—and I can't tell you it's unequivocably so—but for the most part, I know that most of our members who are not in the New York major money centers, are also not part of the nonbank bank environment. They are servicing their clients, both as issuers of securities on the one hand and the investors on the other hand in what I suppose is now a much more conventional securities industry activity, and they are not interested in nor—I suppose I'm now speaking for them which I presume to do—do they probably believe in the nonbank bank as being essential to the providing of these kinds of financial services.

So when you referred to the securities industry, I can take no issue with the point you make that, namely, members of this industry are doing lots of different things. But the Securities Industry Association, and indeed it's that role that I intend to perform this morning, has been very consistent and very unequivocal in its maintenance of the validity of the structural separation of function between commercial banks and the investment banking arena as provided for by Glass-Steagall. And that is a position that the Securities Industry Association today can very properly maintain and it must.

I cannot address the fact though that——

The CHAIRMAN. I understand the game. I used to be vice president of the National League of Cities and there are 15,000 cities in this country and we would formulate a national policy and I'd have to come back and testify both for one of these committees about the National League of Cities policy, and then I'd say, but as mayor of Salt Lake City, I want you to know I have some differences. I understand what you're saying.

The National League of Cities is dominated by the big cities. The rest of them were ignored. And I understand what you're saying and it is that the Securities Industry Association is dominated by the big boys, just like the ABA is, and I have differences with the independent bankers.

Certainly I agree there is diversity. Maybe I ought to start inviting more just individual little bankers and securities institutions and ignore all the normal professional witnesses. I don't know. But the point of it is, can you deny, as you make this case against the banks breaking into any securities-type activity, that the securities industry in general—certainly there are many, many exceptions or not—has been engaging more and more in the last few years—I'll even give you the benefit of bank-like services.

Mr. SHAPIRO. Well, would you be good enough to define "bank-like services" because I cannot accept an affirmative answer to your question when we talk about the deposit-taking functions.

The CHAIRMAN. Third-party checking. Is that a bank-like service, traditionally known only to depository institutions in this country, assured by the FDIC and the FSLIC? Is that a bank-like service?

Mr. SHAPIRO. Yes. There are relatively few members of this association who engage in that activity. There are some, as I stated earlier.

The CHAIRMAN. Well, again, it makes my point, the SIA is making a position, not for all of your members, but the few who

are able to dominate policy, just like all the other institutions—I don't single out SIA for that honor—and that is traditional for trade associations, just like it was the National League of Cities and the U.S. Conference of Mayors and all of them.

Mr. SHAPIRO. I would comment if I might that the enthusiasm for expanded bank powers, I think you would agree, is coming primarily from the very large money center banks and not within the banking industry in total.

The CHAIRMAN. No, no, you're wrong. Large money center banks are willing to dump all the power to prevent regional banking. You'd be amazed at how it's coming from the very small institutions, many of them under $100 million who are having a tough time competing with the local real estate, who would like to be in real estate and so on, and in others.

We're getting back into too much testimony I suppose from New York City and not enough from the vast majority of this country because it isn't just the big banks, and I'm simply not going to continue to allow the discussion always to center on the positions of a few of the biggies in any industry.

I think we'll start changing the structure of some of these hearings and hear from some of the ordinary guys out there suffering and straining to make a living and who have never heard of foreign loans or all of this big finance that they wouldn't understand, but they sure make good automobile loans and commercial loans and they're being heard out there. Some of the small securities dealers who have more of an unbiased viewpoint of the real world.

ISSUE OF STRUCTURE

Mr. SHAPIRO. I do happen to believe, however, that the issue is obviously not only that, but I think as I stated, that it is an issue of structure, and whether or not ultimately we are all better off for it.

Let's, for example, assume total deregulation where absolutely everybody can provide everybody with anything they choose in financial assistance.

Senator GARN. That's never going to happen. Nobody that I know is in favor of that.

Mr. SHAPIRO. Well, I'm under the impression there are some people who advocate it.

The CHAIRMAN. Well, I'm not because that would be an incredible danger to the safety and soundness of traditional depository institutions of this country.

But can't I get you to just weaken a little bit, or will you be drummed out of the SIA to say that there are a lot of securities people who were involved in bank-like services, or are you going to hide that you don't know what bank-like services are?

Mr. SHAPIRO. Mr. Chairman, I didn't deny that. I don't know how to define "a lot of." I don't think it's as many as you believe it to be and I'd be happy, although I certainly don't have the statistics, but I'd be very happy if we could establish what that definition is to respond to you, based upon the records and the information we have as to precisely what those numbers are. That might be helpful to the committee.

The CHAIRMAN. No. As you make this very strong case only oriented toward one side of the equation, that banks should not do these things. If that is fair and banks should not for safety and soundness, then securities industry should stay out of bank-like services.

Mr. SHAPIRO. As I stated earlier——

The CHAIRMAN. Just as a matter of fairness and equity. Forget individual services and mortgage backed securities as a matter of principal and equity.

If banks are not allowed to get in your type of services should the securities industry be allowed to get in bank-like services?

Mr. SHAPIRO. Well, as you have suggested these are broad issues and in many respects we are inevitably dealing with somewhat broad-based generalizations and I think that our position always has been and it remains the position of the SIA that we do believe in fairness. We do believe in equal competition. We have some fundamental differences philosophically with what that structure ought to be as you said before and as I have reiterated today.

The CHAIRMAN. Now, you're getting back to what I understand. Certainly you can have differences of opinion and I understand that, on whether banks should have mortgage-backed securities or municipal revenue bonds. I'm taking it to a general position of equity and fairness.

That is the heart of my irritation with people who come here and insult the intelligence of this committee by being unwilling to admit what is going on in the real world. There has been a dramatic change from the days when we were in that pigeonhole and everybody was doing their thing.

Crossing of services is occurring and if the banks were coming in and saying to me, we want all these expanded powers, but you close everything else out, that would irritate me just as much.

Mr. SHAPIRO. I appreciate and I haven't presumed to suggest that there aren't some organizations which are involved in the securities industry activities, as well as other activities, some of which are, as you have defined it, commercial banking functions in the broadest definition of that term. But we have always argued in favor of the comprehensive review of the whole subject, and we continue to and we will be pleased to be able to participate in specifics as to what we think the consequences of A, B, C, D, E, and F would be, under what circumstances.

But just as it's very difficult for you, sir, it is equally difficult, certainly for myself and for our association to deal with the subject in as general a form as inevitably a dialog as this requires.

We have offered before the SIA, and I am perfectly happy to reiterate this today, that if and when we are to get into a specific discussion, item by item, that we will be pleased to participate, indeed, wish to participate. But what we don't want to see continued is the piecemeal that has been referred to earlier.

I think you agree that that is injurious. Maybe you don't, but certainly, I would maintain that it is.

The CHAIRMAN. Oh, I think you know very well I have tried for a long, long time to have much more comprehensive legislation. I just feel badly about the general principle, and while we certainly argue, and I appreciate your statement about differences of opinion

on individual items and specifics of what power should or should not be granted and who should be doing what, certainly, that is the basis of the argument and why we have tried to bring in everybody to express their opinion.

What are the general principles—and I'll say it just once more, and then I'll quit beating a dead horse—it just surprises me that people are unwilling to admit that there are some elements of unfairness caused by Government, and starting from that point, you heard the other three witnesses. There isn't any real disagreement in trying to protect their own turf, but at least two of them were willing to say, "Yeah, there has been some unfairness, we are willing to fight for individual things." They have as many disagreements as you do. American Express isn't all that pure in the things they're doing, but at least they're willing to admit it.

ABROGATION OF GLASS-STEAGALL POWERS

Mr. SHAPIRO. In its way, it is even more complex than we are. The point that I would like to bring out, if I may, is this, that at least historically as all of us operate within the law. I know you are well aware, and I'm not inviting that anybody sue to the securities industry per se, but as a practical matter, the litigation that has existed, and I think very accurately so, has been initiated by this industry against other industries, specifically, the commercial banking industry. In our opinion—and we believe, you're well aware, the separation that Glass-Steagall Act provides has been, in many cases, very much abrogated by activities of certain competitors of our industry.

The CHAIRMAN. No doubt about it. I have never denied that. You're absolutely correct.

Mr. SHAPIRO. And as you stated earlier and, indeed, it is our purpose, we shall continue to defend what it is we do and the basis on which we do it, and we believe within the stricture of Glass-Steagall. As you are well-aware, we do support it and believe it has functioned well, that this is an appropriate position and appropriate course for us.

The CHAIRMAN. I understand. When you refer to Glass-Steagall, then you are still evading the point of getting into bank-like services which has precipitated this major argument. There would probably be no hearings, there would probably be no discussion of mortgage-backed securities or municipal revenue bonds or anything else, without nonbank banks and third-party checking, and all of the services that are now being provided by competitors like Sears, and all of that probably would not exist.

Mr. SHAPIRO. Well, it may well not. On the other hand, having a great respect for institutions such as the Bankers Trust, Citicorp, and Morgan Guaranty, I know, sitting here today, I truly don't believe that some of the things that they are doing on the one hand and advocating on the other would, frankly, be any different.

The CHAIRMAN. Well, let's quit judging the whole system by the big boys.

Mr. SHAPIRO. No; I made the point with which you agreed in part, that I believe much of the pressure for expanded powers is coming from a relatively few, albeit, very powerful and very large

members of the banking industry. I'm not belittling them for attempting to accomplish what they are, but I recognize and believe they are a great source of the pressure for what we are currently discussing and why we are here. And that's fair enough. It's just that we don't have——

The CHAIRMAN. Well, there you are wrong, because I wouldn't have been doing what I was trying to do, as I made the comment many times, the big boys can take care of themselves. With or without Government, they seem to survive. I repeat again, I represent a very small State with very small financial institutions, and that is where my primary concern is, and the weight of that mass of testimony from literally hundreds and individual communications about where the pressure is coming for an ability to compete. It is an area that you are not familiar with, apparently, but I hear it every day, because I do get out on the stump, not only in my home State but across the country, and those are the ones that I'm worried about, the depository institutions.

Citicorp will survive with Jake Garn or any other chairman, Congresses, Presidents, and so will all the other big boys in the field.

EXPANDED BANK POWERS

Mr. SHAPIRO. So that I understand your point, you are stating that these banks to which you have referred are advocating expanded bank powers and, in particular mortgage-backed securities?

The CHAIRMAN. Not in particular, any one power. A lot of the smaller banks—real small banks in rural areas—would like to have real estate power to be able to compete. They see Sears coming as an example with Coldwell Bankers, the Sears Savings Bank. When they hear talk about buy-ins in insurance, specifically referring to tie-ins in insurance and real estate, they have a little bit of a hard time understanding why everybody rants and raves before this committee about the horrors of tie-ins, and yet Sears can come in and sell you a home through their real estate arm, finance it with the Sears Savings Bank, and then tell you you can get your home insurance on it and your fire insurance and your automobile insurance, and get a discount on the furniture and appliances, if you do the whole package with them; that somehow that's all right.

That's getting back to where double standards bother me.

Now don't misunderstand me. I don't begrudge what Sears is doing, as long as the law allows it. Let them do whatever they can. Let them try and attract their customers. I'm just saying it's unfair to treat people different in the industry.

Mr. SHAPIRO. Well, of course, Sears, as you know, is, indeed, through one of its subsidiaries, involved in the securities industry. Obviously, however, Sears is a whole different animal, a different entity compared to what most of the members of this association are all about. I'm not belittling Sears for that, but I am drawing the distinction between organizations such as Sears, which have many, many, many different activities and many more varied activities than most SIA members. Indeed, like the small bank to which you referred, that is interested in real estate powers, an

issue where our association and our industry, has no position, I think it might be a mistake if ultimate legislation was focused only on what Sears, Roebuck does or doesn't do. And I'm not suggesting that's what you're proposing, but I do want to make the point that the securities industry is obviously not Sears, Roebuck of and by itself. Far, far from it. And I agree with you, Sears, Roebuck's existence and the very fact that they have such diversity of activity complicates this whole subject, absolutely.

But again, that's why I do emphasize, that the ultimate structure—and that is clearly for you gentlemen to determine—is what it really is all about. Not so much an item by item assessment of what the cause and effect would be of expanding a particular power, because whether or not people who are not in the securities industry should be permitted to underwrite mortgage-backed securities, is a very specific issue, and there are lots of elements that come into play, but they can be pretty well-defined.

What we have been addressing and what we are emphasizing and continues to be essential is that the overall structure is the issue that must be addressed. That's what this committee is all about.

The CHAIRMAN. Well, that's what we've been trying to do for a long, long time. Again, if the securities industry's hands were clean, this debate would not even be taking place.

And I'll just let you run and catch your plane on that note.

If securities firms weren't trying to get into the banking business, the banks would have no sympathy for me at all for trying to get into securities-type activities.

Mr. SHAPIRO. I'm not sure which came first, the chicken or the egg, Mr. Chairman. I'm really not.

The CHAIRMAN. If we started debating the chicken and egg, you wouldn't even be making the 6 o'clock plane.

Mr. SHAPIRO. I will make one last point. I do believe that many of the actions that have been taken by firms that are principally securities firms have been, in response to what they feel have been competitive needs that will serve their clients on the one hand and to be able to preserve the position that they have on the other. The nonbank bank question is a very difficult one, as you can appreciate. Within our industry, there are different points of view, and it is for that reason that the association itself does not have an expressed position at this point in time as to what should or not be done with the nonbank bank.

But what we don't want to see happen is that the nonbank bank becomes the only issue. That we think would be a great mistake.

The CHAIRMAN. Thank you very much. And I thank Mr. Silver for allowing you to finish.

Mr. SHAPIRO. Thank you, sir.

The CHAIRMAN. Mr. Silver.

STATEMENT OF DAVID SILVER, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. SILVER. Good morning, Mr. Chairman. I am David Silver, president of the Investment Company Institute, the national association of the American mutual fund industry.

Mr. Chairman, unlike Mr. Robinson, I am not going to give up trying to persuade you. As the tailgunner, I guess, I'm not quite sure whether this is a place of honor or disgrace at the end of 4 years of hearings, but I'll give it one last shot anyway.

I do appreciate this opportunity to present our views. You have been most patient and most generous over this period to people that you agree with, disagree with, people who you partially agree with and partially disagree with, and even with the people who were speaking about things which were not relevant to these hearings. Throughout, you have maintained your patience and courtesy with us all, and I thank you again.

ACTIVE PARTICIPANTS FOR 4 YEARS

We have been active participants during all 4 years of these hearings and, as such, we share the frustration over the failure to achieve a consensus. I'm going to try to use most of the time you have given me this morning to try to cast some light on the reasons for the present impasse.

First, we would offer an observation which I don't think has been made, at least not today nor as far as I can read in the transcripts, that there is no demand from the public to concentrate a greater degree of the Nation's financial activity in the depository sector. Indeed, when asked, much of the public is skeptical about increased bank powers. Expansion of bank powers is not consumer-driven. In fact, a comprehensive survey by the Federal Reserve Bank of Atlanta in 1984 found—and I quote:

> Most U.S. households currently prefer to continue obtaining banking services from banks, insurance from insurance companies, and brokerage from brokerage firms.

A subsequent study conducted for the American Banker, a respected banking trade publication, published in 1984, found that only one-third of the respondents favored further expansion of bank power. This survey concluded, and again I quote:

> While bankers claim the public will be the ultimate beneficiary of deregulation, this opinion is not shared by the American public. The public seems satisfied with banking as it is and despite a strong minority favoring deregulation, the majority think it might create problems.

The second point which has contributed to the present impasse is that many of the issues under congressional scrutiny have also——

The CHAIRMAN. Can I just ask you one question at that point? I don't dispute the survey or make any argument with you at all, but surveys depend on what question is asked. You're correct, it isn't consumer-driven or customer-driven. But they were told in the questioning that other types of competitors would threaten their traditional depository institution. In other words, I don't think they understand the whole equation across terms we have talked about ad nauseum today.

Do you think that is a fair statement to say that, where I grant you it's not consumer-driven, but asking that kind of a question, sure, they're going to say, Gee, we don't need any more powers, our bank is just fine, without understanding the dynamics of a new competition, and so on.

Mr. SILVER. I certainly grant you that, Senator, one can get answers by loading the questions. I would simply point out that none of the surveys I'm talking about were conducted by securities-affiliated organizations.

The CHAIRMAN. No, I agree, and I don't even mean the question was loaded, because I start off by agreeing with you that I would expect that would be the result of any type of question like that, but they don't understand all of the activities that other types of firms, including insurance firms and Sear's, are getting into as a threat to their traditional banking situation.

Mr. SILVER. I'll grant you that certainly, but I think the survey that came closest to what consumers felt found, that although there were a number of undecideds, 50 percent answered the question as to whether banks should have greater powers by expressing the belief that this would lead to an undue degree of economic concentration. I think that this did reveal the degree of concern and the sophistication of the general public, something which those of us who discuss these issues all the time would not have otherwise expected.

The CHAIRMAN. Well, I would still agree with you on that point, too, but it doesn't make the other point I was making in opposite. Please go ahead.

Mr. SILVER. The second point is that during the course of these hearings, many of the issues which you have been studying have also been the subject of active litigation. In itself, I think this is a fact which acts as a drag on a legislative resolution of the problem. However, I would point out that now the courts are starting to sort out the legal confusion and bring some order back into the regulatory chaos.

I am not here today, however, to urge that the legislative process come to a halt for the lack of public demand for increased bank powers or because the courts may unscramble the regulatory omelet.

We realize that the world changes and that our financial system changes with it. However, despite all the time and attention we have all devoted to this issue, an answer has not yet emerged to the all important question: What kind of financial services industry do we want?

Reviewing as dispassionately as we can the committee's hearing record over the last several years, it almost appears as if the committee has been conducting two separate sets of hearings. These two separate approaches, we believe, are mainly responsible for the present impasse and the ensuing frustration.

The first set of hearings reflects a banking perspective. Banks perceive the removal of limitations on the powers of banks to be a simple issue of bank deregulation. As to securities activities, the bill only need state that the Glass-Steagall Act is repealed.

The second approach to these hearings looks at bank expansion into other financial services as a revolutionary change, not an evolutionary step. We and others have pointed out that for over 120 years our Nation's laws have treated commercial banks as special.

In line with this view, commercial banks have been granted unique privileges and protections. On the other hand, Federal law

has imposed restrictions on their activities, including both geographical limitations and limitations on nonbanking activities.

How banks' entry into other businesses can be reconciled with their existing privileges and restrictions is an issue of paramount importance. Whether those with whom the banks would compete can themselves become banks, and on what terms, is also a question of major significance.

THREE ISSUES THAT PROPONENTS HAVE IGNORED

Above all, these two issues must be addressed and recognized before any consensus can be achieved. Today, we will merely mention the three issues that proponents of expanded powers have substantially ignored—competition in banking, the historical record of abuse, and the concentration of economic power. We conclude with what we believe would be a sensible program for the future.

The banking perspective on new bank powers has tended to submerge the fact that another great financial industry—the securities industry—is also vitally affected by the expansion of nontraditional banking powers.

Today, there are 5,954 securities firms registered with the NASD. These firms employ some 330,000 registered representatives. The major securities firms are organized on a national basis with branch offices throughout the Nation. Other securities firms are regionally based. Risk is a natural ingredient of the securities business, a business which has provided equity financing for the great industrial and commercial enterprises that have made this country strong and made it a country whose capital markets remain the wonder of the world.

Unlike bank regulation which seeks to insulate banks from the vicissitudes associated with the economic cycles, regulation of the securities industry is not designed to protect our business from failure, but to protect our customers from fraud.

So, to begin with, we have two very different industries serving related but different functions which involve very different predicates as to business risk and the goals of regulation.

A one-sided program which would permit banks to expand into the securities business, but would also shelter banks from competition in banking, in the name of safety and localism, is not only unfair but would also undermine the health of America's securities industry.

I might add that I have heard people eloquently argue to close the nonbank bank loophole, to oppose interstate banking, and then to express support for giving banks a number of securities powers. There is an inherently elusive logic in the proposition that a California bank in San Francisco or a Wisconsin bank in Madison should be able to offer a broad spectrum of banking and securities services, while the branch offices of regional and national securities firms down the block are barred from the banking business.

I, for one, do not understand the economic calculus which says that this will lead to increased competition and continued viability of a separate securities industry.

The bank deregulatory viewpoint also ignores the problems associated with bank affiliates which history has amply documented.

I have read in the hearing transcripts and in other papers that the larger banks have lately taken to ridiculing the Glass-Steagall Act as a product of bogus economics. It should be recorded, however, that Senator Glass was not alone in advocating separation of the two industries. President Hoover as well as Franklin Roosevelt endorsed these proposals during the 1932 campaign. It is noteworthy that in its very first issue in 1930, Fortune Magazine questioned the propriety of bank securities activities.

To the extent that large banks are compelled to recognize that Glass-Steagall did address real problems, they continue to endorse the separate affiliate approach as a panacea. Yet, we had such diverse witnesses as Chairman Volcker, the FDIC, and Walter Wriston, who have told this committee that the fortunes of a bank cannot be separated from its affiliates. We agree. Separate affiliates did not provide protection in the 1920's or when the bank-affiliated REIT's got into trouble in the 1970's.

Thus, if banks are allowed to reenter the securities business, it will be necessary to create a stronger, better integrated regulatory system to replace the prohibitionist approach of Glass-Steagall.

DISREGARD OF FINANCIAL RESOURCES CONCENTRATION

A final failure of the bank deregulatory approach is the disregard of a potential increase in the concentration of financial resources.

To the extent the banking industry has treated this issue, they have ignored a central competitive reality of our financial system. Although there may be concentration within certain segments of our financial system, there is a great deal of competition between these segments.

For example, bank money market deposit accounts compete vigorously against money market mutual funds. Banks, securities firms, and insurance companies compete for the management of hundreds of billions of dollars of pension and retirement plan assets. These firms compete aggressively to finance corporate debt. Business borrowers have the option to choose between bank loans and issuing commercial paper or bonds. We strongly believe that if the Glass-Steagall Act is repealed, large banks, with their huge assets and competitive advantages, would quickly become giant financial conglomerates. They would rapidly acquire or merge with most of the significant firms in the securities business, a result that would inevitably reduce, rather than increase, competition.

But we have done more than compile a list of the problems I have sketched this morning. We have offered specific legislative solutions. We believe that our seven legislative suggestions are soundly based on principle and also contemplate a realistic framework for the future, if, indeed, the Glass-Steagall Act is to be substantially modified.

These proposals are set forth in our written statement, and I will not repeat them. Briefly stated, they are designed to move toward an evenhanded regulatory structure and to provide for fair competition between all sectors of the financial services industry. This program is admittedly far-ranging and complex. Its implementa-

tion would require hard work, careful study, and a spirit of compromise.

Our proposals are not based on abstract theory, but on the historical record. Legislation devoid of provisions to control the inherent conflicts of interest between commercial and investment banking is simply a recipe for the repetition of financial disasters. One-sided legislation, which does not provide for competition in banking, as well as in securities business, is a recipe for concentration of financial services in the banking sector.

Unless and until these issues are addressed by all the parties, the two threads of these hearings will never intertwine, and our shared frustration will continue.

In our testimony, we have tried to focus on the broad policy questions faced by the committee and not address the impact of particular proposals upon the mutual fund industry. Last year a bipartisan majority of this committee specifically rejected providing commercial banks with mutual fund powers. Nothing has happened since to undermine the wisdom of this conclusion. Nonetheless, we are hopeful that we can make a contribution to the long-term resolution of the legislative issues involved in the restructuring of the financial services industry. The continuing controversy unsettles our financial marketplace, diverts business planning into an irrational search for loopholes and robs our legal and business institutions of public credibility.

The issues we have raised are important, and we have presented them to you in all good faith. We hope that the committee and all concerned will give them the serious consideration they need, and I am certain, Mr. Chairman, I have persuaded you this morning.

[The complete prepared statement follows:]

Statement of David Silver
President
Investment Company Institute

Before the
Senate Committee on
Banking, Housing and Urban Affairs

June 20, 1985

I am David Silver, President of the Investment Company Institute, the national association of the mutual fund industry. The Institute has 1,161 mutual fund members with over 20 million shareholder accounts and $378.1 billion in assets.

We welcome the opportunity to participate in these hearings. Indeed, we are grateful for the opportunities we have been given over the past four years to share our views with this Committee concerning the proper role and regulation of financial institutions. As active participants in this process we appreciate, in fact we share, the sense of frustration expressed by members of the Committee over the failure to achieve a consensus.

We do not believe that merely repeating our industry's views and data would make any useful contribution at this time. The various points we urged last year before this Committee remain sound and nothing has occurred in the interim which would require any new or different analyses of the issues. Therefore, we would like to use the time allotted to us to see if we can help cast some light on issues which have contributed to the present impasse.

The first reason for the lack of a consensus on expanded bank powers is that there is no demand from the public to concentrate a greater degree of the nation's financial activity in the depository sector. Indeed, when asked, much of the public is skeptical about increased bank powers.

Thus, despite claims to the contrary by the large banks, there is no clamor for expanded bank powers coming from consumers. In fact, a comprehensive review of consumer surveys published by the Federal Reserve Bank of Atlanta in May 1984, including a survey by the Bank itself, found that "most U.S. households currently prefer to continue obtaining banking services from banks, insurance from insurance companies, and brokerage from brokerage firms."1/

A subsequent study conducted by Reichman Research for the American Banker, published in October 1984, found that only one-third of the respondents favored further expansion of bank powers.2/ Fully half were opposed and the remainder unsure about the wisdom of moving in this direction. This opposition is related to the ability of banks to diversify while efficiently handling their central function of deposit management. Consumer respondents also expressed concern over the effects of expanded bank powers on the concentration of economic resources and the possible loss of alternative sources of financial services.

The Reichman report stated:

> "While bankers claim the public will be the ultimate beneficiary of deregulation, this opinion is not shared by the American public. The public seems satisfied with banking as it is, and despite a strong minority favoring deregulation, the majority think it might create problems."3/

The results of this study are astounding when one thinks of the relatively exotic nature of these issues.

The second point which has contributed to the present impasse is that many of the issues under Congressional scrutiny have also been the subject of active litigation. Now the courts are starting to sort out the legal confusion which the bank regulators deliberately created to stampede Congress into taking action.

The Supreme Court has just handed down a definitive holding on one important aspect of the interstate banking issue. In another hotly contested area, the recent decision of the 11th Circuit Court of Appeals in the U.S. Trust case has virtually stopped the nonbank bank movement in its tracks. We might note that the court in this case pointed out that regulators "ought not apply the literal terms of a statute to reach a result contrary to the underlying policy of Congress." This observation is hardly a new legal doctrine. As I have said before at these hearings, this is supposed to be a basic canon of behavior for administrative agencies. Such agencies are expected to use their expertise and their authority to support, not destroy, the regulatory framework committed to their care.

Recognition of the Problems as a First Step to Legislation

We are not here today, however, to urge that the legislative process come to a halt because there is little current public demand for increased bank powers or because the courts may unscramble the regulatory omelette. We realize that the world changes and that our financial system and its regulatory framework should change with it. The point is, however, that there is no urgent legislative need. Ample time still exists for in-depth consideration of the difficult and complex public policy issues presented by expansion of bank powers. The attention devoted to these issues to date has yet to establish a solid basis for change or to answer the all-important question: What kind of financial services industry do we want?

Reviewing as dispassionately as we can the Committee's hearing record over the last several years, it almost appears that the Committee has been conducting two separate sets of hearings. These two separate approaches, we believe, are mainly responsible for the present impasse and ensuing frustration.

The first set of hearings reflects a banking perspective. Here, the large banks and their allies remain frustrated because little progress has been made on what they consider to be a straightforward and simple issue of bank deregulation, i.e., the removal of limitations on the powers of banks. From this perspective, all that is required is a simple bill granting new bank powers with respect to securities, insurance, real estate

and other lines of commerce. In the area of securities activities, the bill only need state that the Glass-Steagall Act is repealed.

However, we think that relatively few people have bought the idea that the issue is really so simple: that the barriers between commercial and investment banking can be removed without addressing the regulatory and competitive problems that would inevitably result from such a fundamental change of national policy.

The second approach to these hearings has been primarily advanced by the securities industry, although many of its underlying premises have been shared by other witnesses. In a nutshell, this view looks at bank expansion into other financial services as a revolutionary change, not an evolutionary step.

We and others have pointed to the fact that for over 120 years our nation's laws have treated commercial banks as "special." As Chairman Volcker stated last April in testimony before a subcommittee of the House Committee on Banking, Finance and Urban Affairs:

> "Public policy has long recognized that commercial banks perform a unique and critical role in the economy and the financial system. They are operators of the payments system; they are custodians of the bulk of liquid savings; they are the principal suppliers of short-term credit; and they are the critical link between monetary policy and the economy. Moreover, the fortunes of individual institutions are so intertwined that instability of one may infect another."4/

In line with the view that banks are "special", commercial banks have been granted unique privileges (e.g., limits on entry into the banking business, bank access to the Federal Reserve System as the lender of last resort, federal insurance of bank deposits, etc.). On the other hand, federal law has imposed limitations on the activities which may be conducted by banks, including both geographical limitations (e.g., restrictions on interstate banking) and limitations on activities (e.g., prohibitions against banks and their affiliates engaging in securities, insurance, real estate and other non-banking activities).

How bank entry into other businesses can be reconciled with their existing privileges and restrictions is an issue of paramount importance. Whether those with whom the banks would compete can themselves become banks, and on what terms, is also a question of major significance.

However, the Committee's hearing record over the years reflects an almost total communications gap between those who ask these questions and those who think the entire issue is one of simple deregulation. Until and unless people recognize and address the same problems, even if to disagree, a consensus can never be reached on the issues. Analysis of bank deregulation solely from a banking perspective is not only narrow, but illogical. Every sector of the financial services industry must

be considered, for each represents a viable industry, each is a major contributor to the health of the nation's economy.

Today we will try to highlight a number of issues in areas the proponents of expanded bank powers have chosen to ignore, namely, the problems associated with industry competition, the historical record of abuse, and the concentration of economic power. We will also present again what we believe is a sensible program for the future.

The Competitive Problem - A One-Way Street

The banking perspective on new bank powers has tended to submerge the fact that another great financial industry -- the securities industry -- is also vitally affected by decisions as to the scope of non-traditional banking powers and restrictions on entry into banking. Today there are 5,954 securities firms registered with the National Association of Securities Dealers, Inc., which employ some 330,000 registered representatives.

The major securities firms in the country are organized on a national basis with branch offices throughout the nation. Other securities firms are regionally based and maintain branches in several contiguous states and their metropolitan areas. Through these extensive networks of branch offices and their registered representatives, a host of securities products and services are brought to the public. Equity financing of new and

existing businesses is arranged through securities offerings which depend on this distribution network.

Risk taking is the natural ingredient of the securities business, a business which has provided equity financing for the great industrial and commercial enterprises that have made this country strong and prosperous -- a country whose capital markets remain the wonder of the world. Today, the process continues as new emerging technologies attract venture capital and start climbing the ladder of growth and success.

Unlike bank regulation which seeks to insulate banks from the vicissitudes associated with the economic cycles of our free enterprise system, regulation of the securities industry is not designed to protect our business, but to protect our customers. Securities regulators do not share a view parallel to that expressed by Chairman Volcker that commercial failure of a regulated entity is inextricably intertwined with the economic health of the entire country.

So, to begin with, we have two very different industries serving related but different functions and which involve very different predicates as to business risk and the goals of regulation. Thus, we and others in the securities industry have been frustrated by the continuing failure of the advocates of expanded bank powers to acknowledge and address the multitude of issues which arise from a program which would permit banks to expand into the securities business, but would also shelter banks from competition in the name of safety and localism. The effects

on the health of America's securities industry, if a core of securities powers is granted to banks, is an issue which has never received the examination it deserves -- and it never will so long as the perspective remains solely that of bank deregulation.5/

Various witnesses and some members of the Committee have expressed extreme reluctance to permit interstate banking or to completely repeal the Glass-Steagall Act. However, some who express these views are also vigorous proponents of giving banks a number of securities powers. There is an inherently elusive logic in the proposition that a Texas bank in Dallas, or a California bank in San Francisco or a Wisconsin bank in Madison should be able to offer a broad spectrum of banking and securities services, while the branch offices of regional and national securities firms down the block are barred from the banking business. If there is an economic calculus which says that this will lead to improved competition and a healthy securities industry, it would seem to be a well-kept secret.

The Historical Record of Abuse -- Solutions Must be Found

One of the most significant contributions to the current impasse is that the bank deregulatory viewpoint ignores the historical record -- ignores the problems which have arisen in the past when the securities industry, based on risk, merged with the banking industry, which is based on safety.

The large banks, which refuse to acknowledge the difficult problems which did emerge and which will inevitably reemerge from a repeat of this amalgamation, have lately taken to ridiculing the Glass-Steagall Act as the product of a single fanatic, Senator Glass, who, they claim, relied on bogus economics in fashioning his bill.6/ It should be recalled, however, that Senator Glass was not alone in advocating separation of the two industries. President Hoover, in his first annual message to Congress, recommended that consideration be given to separating commercial and investment banking.7/ Even following his defeat in 1932, Hoover urged Congress to pass divorcement legislation during the lame duck session.8/ The 1932 Democratic platform also urged the "divorce of the investment banking business from...commercial banks..." and Franklin Roosevelt endorsed these proposals during the campaign.

Presidents Hoover and Roosevelt were not alone in these concerns. In the first issue of Fortune, published in February 1930, the magazine expressed skepticism about the inter-relationships between commercial and investment banking. While recognizing a great profit potential for commercial banks in the underwriting field, Fortune questioned "whether the cooperation may sometimes be too close, thus getting the bank into promotional difficulties of which it should be judge rather

than advocate." Such practical concerns have nothing to do with the economic exotica which the banking industry has recently argued are the basis of the Glass-Steagall Act.

It should also be noted that even major banks with securities affiliates eventually supported enactment of Glass-Steagall. On March 8, 1933, Winthrop Aldrich, President of Chase National Bank stated:

> It is impossible to consider the events which took place during the past ten years without being forced to the conclusion that the intimate connection between commercial and investment banking almost inevitably leads to abuses."9/

It is the failure of today's large banks to acknowledge the unhappy history of bank securities affiliates, much less to offer solutions to the problems they created, which contributes to the current impasse and the continuing unease about unraveling Glass-Steagall.

Despite its discredited history, the large banks continue to endorse the separate "affiliate" approach as a panacea. However, many others have recognized that reliance on an affiliate system between a banking organization and its securities component will not work without other appropriate safeguards. Chairman Volcker and the FDIC have told Congress that the fortunes of a bank cannot be separated from its affiliates. In fact, former Citicorp Chairman Walter Wriston admitted this in response to a question from Senator Heinz:

"Lawyers can say you have separation but the marketplace is persuasive and it would not see it that way."10/ We agree. Separate affiliates did not provide protection in the 1920s or when bank-affiliated REITs got into trouble in the 1970s. There is no reason to believe that they will provide such protection today.

In addition, application of the existing federal banking laws to proposed bank securities activities will not address the issues of public protection. As former SEC Chairman William Cary testified in 1963:

> "The great objectives of banking regulation are controls over the flow of credit in the monetary system, the maintenance of an effective banking structure, and the protection of depositors. These objectives neither utilize the same tools nor achieve the same ends as investor protection."11/

Also insufficient is the application of existing securities laws to proposed bank securities activities as recognized by SEC Chairman Shad,12/ the North American Securities Administrators Association,13/ and Chairman Volcker.14/ Congress enacted these laws on the assumption that the Glass-Steagall Act prohibited commercial banks from engaging in the securities business. Therefore, while the securities laws address specific problems which arise when investment banking firms, broker-dealers and investment advisers engage in securities activities,

they are totally silent with respect to the unique problems presented by the securities activities of commercial banks.

Thus, if the Glass-Steagall Act is to be significantly modified to allow banks to reenter the mainstream of the securities business, it will be necessary to create an integrated regulatory system to replace the prohibitionist approach taken by Glass-Steagall. However, to achieve this end, two different industries and two very different systems of regulation, having different goals, must be accommodated. The regulatory gaps caused by the long legal separation of the two industries must also be filled. The present pattern of exemptions and exceptions based on this separation must also be thoroughly reexamined.

Concentration of Economic Power

A final failure of the bank deregulatory approach is the disregard of an exceedingly important issue: the increase in the concentration of financial resources which would result from expanding bank securities powers. The absence of any close examination of this issue has permitted banks to hide behind a simple-minded smoke screen; selecting only those banking and securities functions which illustrate that segments of the securities industry are more concentrated than are segments of the banking industry.

However, even if the banks' assumptions and statistics were correct, they have ignored a central competitive reality of our financial system. Although there may be concentration within

certain segments of our financial system, there is a great deal of competition between these segments. For example, money market deposit accounts of commercial banks compete vigorously against money market funds sponsored by securities firms. Banks, securities firms and insurance companies compete for the management of hundreds of billions of dollars of pension and retirement plan assets. These same firms also compete aggressively to finance corporate debt. The fact that businesses have the option to choose between bank loans and issuing commercial paper or bonds has had a beneficial competitive impact on all three financial sectors. If the Glass-Steagall Act is repealed, large banks, with their huge assets and competitive advantages, would quickly become giant financial conglomerates, a result that would inevitably reduce, rather than increase, competition.

As authority for this conclusion we have an excellent source, Citicorp, the largest bank holding company and, in fact, the largest company by asset size in the United States, with assets of $150 billion.15/ Citicorp's assets exceed those of any other company: of AT&T, GM, IBM, Exxon, none is larger. This one company's assets exceed the combined assets of all stock and bond mutual funds. In recent years, Citicorp's revenues exceeded those of all but two states, New York and California.

Citicorp does business with one out of every seven U.S. households, it is the nation's largest bank credit card issuer, and the world's largest private foreign lender.

In 1984, Citicorp told financial analysts that it plans to be the major player in virtually every market for consumer finance. According to published reports, Citicorp's representatives explained that this would occur because Citicorp was smarter and more disciplined than its rivals. The American Banker, however, believed that a major reason for this optimism was based on the fact that the holding company's resources would give each of its individual divisions an edge over competitors.16/ There should be no doubt that the large banks are quite willing to use their special protections and advantages to expand their market share to the detriment of their nonbank competitors.

At the end of 1984, the banking sector had total assets of over $3.3 trillion, compared to about $370 billion for all types of mutual funds. Because of the enormous size of the banking industry, it dominates many individual markets. The financial assets of banks, for example, represent about 36 percent of the total financial assets of major types of financial institutions, and the value of bank trust stock outstanding accounts for over 40 percent of the value of all stock held by financial institutions. Thus, banks are concentrated within specific markets as well as in the banking sector itself. This is

generally not the case in other industries because the level of concentration is much lower than in banking.

Last year we distributed a study on the probable economic results of bank entry into the mutual fund business.17/ The study concluded that the ability of banks to create and to sell mutual funds on a continuous basis, combined with the probable acquisitions of large mutual fund advisory firms by the largest banks, would greatly increase the equity holdings of the banking sector. Bank concentration in the stocks of individual companies and industries would likewise expand further. This, in turn, would enhance the possibility for bank control over parts of American industry and exacerbate the potential for conflicts of interest. The study continues to be the most exhaustive of its kind to date. Its conclusions are totally contrary to the large banks' arguments that new bank securities powers would increase competition. If banks are to reenter the securities business, very careful attention must be given to fashioning specific safeguards against concentration. To date, this has not been done.

A Program for the Future

The Institute has considered the many problems raised by the legislative proposals thus far considered by the Committee and has offered specific legislative solutions in the investment company area. As early as 1983, we discussed our concerns with then Deputy Treasury Secretary McNamara and his staff and, at his

invitation, submitted a detailed memorandum identifying major deficiencies in the Treasury Bill and a series of specific amendments designed to remedy them.

We believe that our suggestions are not only soundly based on principle, but also contemplate a realistic framework for the future. If indeed the Glass-Steagall Act is to be substantially repealed or modified, we have urged seven points for legislative attention. Let me summarize them:

(1) All bank securities activities should be conducted in separate holding company affiliates;

(2) Banks and their securities affiliates should be strictly regulated to assure their legal and functional separation;

(3) All new securities activities of bank affiliates should be subject to SEC regulation;

(4) All present bank securities activities should likewise be subject to SEC regulation;

(5) The securities laws should be amended to deal with the special problems arising when affiliates of commercial banks engage in retail securities activities;

(6) The securities and banking laws should be modified to provide for a flexible regulatory framework for all collective investment funds so as to provide common regulation for like products; and

(7) Restrictions on entry into banking and geographic limitations should be eased so that securities firms and banking organizations can compete on an equal basis throughout the nation.

This program is admittedly far-ranging and complex. Its implementation would require hard work, careful study and a spirit of compromise.

Thus far, however, our proposals have been ignored by most proponents of expanded bank powers. They refuse to see that ending the long legal cleavage between commercial and investment banking would require ending the wide disparities which now exist between banking and securities regulation. This is unfortunate since our proposals in this regard are not based on abstract theory but on an historical record of grave abuse -- abuses which must not be repeated. Legislation devoid of provisions to control the inherent conflicts of interest between commercial and investment banking activities is simply a recipe for the repetition of financial disasters, disasters which marked the culmination of previous experiments which permitted banks to mass-merchandise securities.

Until and unless these issues are addressed by all parties, the two threads of these hearings will never intertwine and our shared frustrations will continue.

****

In our testimony today, we have tried to focus on the broad policy questions faced by the Committee and have not addressed the impact of a particular proposal upon the mutual fund industry. Last year a bipartisan majority of this Committee specifically rejected providing commercial banks with mutual fund powers. Nothing has happened since to undermine the wisdom of this conclusion. Nonetheless, we are hopeful that we can make a contribution to a long-term resolution of the legislative issues involved in the restructuring of the financial services industry. The continuing controversy unsettles our financial marketplace, diverts business planning into an irrational search for "loopholes" and robs our legal and business institutions of public credibility.

The issues we have raised are important and we have presented them to you in all good faith. We hope that the Committee and the banking industry will give them the serious consideration they need. If Congress is going to make fundamental changes in the basic structure of the financial services industry, a structure which has served this nation so well for the past fifty years, then careful preparation is required so as to lay the groundwork for another fifty years of growth and prosperity.

Footnotes

1/ Veronica Bennett, "Consumer Demand for Product Deregulation," Economic Review, Vol. LXIX, No. 5, May 1984, at 29.

2/ Reichman Research, Inc., "An Opinion Survey: The American Public's View of Current Banking and Financial Issues," October, 1984, at 12-13.

We are appending hereto as Appendix A a paper prepared by the Research Department of the Investment Company Institute that reviews the various consumer surveys concerning the amalgamation of the financial services industries and related issues.

3/ Id, at 13.

4/ This view leads inevitably to a protective regulatory system which measures change against the sensitive function that banks perform. Thus, while Chairman Volcker may take a more restrained view of increased bank powers than other regulators, he does so from a sense of the health of the banking system. His analysis is wholly within the banking frame of reference with little or no consideration of the effects of change outside the banking system.

5/ For instance, when the Chairman and Chief Executive Officer of Chemical Bank testified before the Committee on May 15, he suggested that a committee be formed to implement a transition to geographic and product deregulation. However, he recommended that the committee be composed entirely of Federal and State bank regulators. Although he admitted that the issues posed are extremely complex, and stated that the details should be removed from political pressure, he failed to realize that much more than the interests of the banking industry would be involved in such a change. The absence of the Securities and Exchange Commission and the North American Securities Administrators Association, for instance, from such a governmental committee virtually guarantees that investor protection will receive short shrift. The absence of anti-trust experts similarly indicates a lack of concern with concentration of economic resources.

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6/ Thus, in a recent paper, J. P. Morgan & Co. has argued that Senator Glass was captivated by fringe economic thinking known as the "real bills" theory.

7/ V. Carosso, Investment Banking in America, A History 368 (1970).

8/ E. Perkins, "The Divorce of Commercial and Investment Banking, A History," 88 Banking L.J., No. 6, 520-21 (1971).

9/ New York Times, March 8, 1933.

10/ Hearings on S. 1686, S. 1703, S. 1720 and S. 1721 before the Senate Committee on Banking, Housing and Urban Affairs, 97th Cong., 1st Sess., pt. 2, at 589-90 (1981)(1981 Hearings).

11/ Testimony of William Cary before the Senate Subcommittee of the Committee on Banking and Currency, SEC Legislation 1963: Hearings before a Subcommittee of the Committee on Banking and Currency, United States Senate, 88th Cong., 1st Sess., 20 (1963).

12/ Statement of Chairman Shad, 1981 Hearings, at 914.

13/ Hearings on S. 2181 and S. 2134 before the Senate Committee on Banking, Housing and Urban Affairs, 98th Cong., 2d Sess., pt. 2, at 943-944 (1981).

14/ Statement of Chairman Volcker, 1981 Hearings, at 466.

15/ Forbes, Vol. 135, No. 9, April 29, 1985, at 192.

16/ "Citicorp Pushing Consumer Finance," American Banker March 7, 1984.

17/ "Proposed Bank Entry into Mutual Funds: Some Economic Policy Issues," Investment Company Institute, 1984.

APPENDIX A

FURTHER EXPANSION OF BANK POWERS: NOT CONSUMER DRIVEN

June 20, 1985

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A. INTRODUCTION

In recent years, many banks have successfully broadened their product lines and expanded the geographic boundaries of their markets, either through deregulation or creative interpretation of existing laws. Other banks, primarily the giants of the industry, have consciously set out to become "financial supermarkets." The development of such entities would, according to their advocates, enable consumers to engage in one-stop financial shopping and to effectively manage their financial positions from the cradle to the grave.

Despite the broadening of bank powers that have already been achieved, pressures for more deregulation persist. These pressures arise because of apparent perceptions among some bankers of the need to adapt their activities to: generally higher interest rate levels, more volatile financial markets, and shifting demands of savers and investors.

Whatever the merits of this position, it should be emphasized that the driving forces behind deregulation are banking efforts to stabilize revenue flows and to enhance profits. In short, the push for further expansion of powers comes primarily from large banks. It is not consumer driven.

Only about 1 in 3 consumers support a further expansion of bank powers. The remaining 2 in 3 say it is not a good idea or are unsure of what course should be taken. Many of those who oppose a broadening of bank powers (50 percent of all respondents) do so because they think it will make banks too diversified or give them too much power. A significant percentage of this latter group also indicate that they have lost confidence in the banking system in recent years because of the troubles that some banks have experienced. Finally, it is clear that expansion of bank powers to date has been accompanied by an increase in costs, but the question remains as to the increase in benefits. There is substantial evidence, for example, that bank fees have increased for a variety of services and, in some instances, the availability and quality of services have declined. These latter developments have presumably dampened the enthusiasm of some consumers for granting banks new powers.

These and other consumer reactions to deregulation will be reviewed in greater detail below. The findings are drawn from a number of publicly available surveys and studies.

B. CONSUMER CONFIDENCE IN BANKING IS WANING

The public's confidence in the U.S. banking system, while still high, has been weakened with expanded bank powers and the added risks assumed by banks. A survey conducted for the American Banker newspaper by Reichman Research, Inc., found that

at present 31 percent of the respondents have a "great deal" of confidence in the banking system. Sixteen percent of the respondents have very little or no confidence in the system, and 2 percent are not sure. Fifty-one percent indicated "some" confidence. \1 Possibly of greater significance, though, is that the trend in consumer confidence in the banking system has been falling in recent years.

Respondents were asked to compare their confidence in the U.S. banking and financial systems today with that of a few years ago. Those who indicated they had less confidence (36 percent) were more than double those who said they were more confident now (16 percent). About 46 percent indicated there had been no change in their confidence level and 2 percent were not sure.

Those who said they were less confident today gave several reasons. Twenty-five percent attributed their lower confidence level to "too many banks going out of business," 18 percent attributed it to "too much money loaned to foreign countries," and 18 percent felt it was due to an unstable economy. \2 The other reasons given with somewhat less frequency by respondents, whose confidence in the banking system has declined, were: banks are often incompetent/poorly managed (9 percent), interest rates on loans are high/too high (8 percent), and banks are not trustworthy/are dishonest (7 percent).

To repeat, public confidence in banking -- while still high -- is eroding. Confidence levels have been undermined by the publicity associated with foreign loan problems of banks and the need for government assistance to keep some banks afloat. The outright increase in the number of bank failures and problem banks has also undoubtedly contributed to loss of confidence in banking.

C. LITTLE EVIDENCE OF CONSUMER SUPPORT FOR EXPANDED BANK POWERS

In this section, the degree and urgency of consumer support for expanded bank powers will be assessed. In addition, consumer attitudes toward one-stop and one-source financial shopping will also be reviewed.

- o Expanding Bank Powers and Product Lines

  The Reichman survey conducted for the American Banker examined consumer support for bank entry into new lines of business in general. The study did not emphasize particular areas of expanded bank powers or product lines.

The Reichman study found that 50 percent of the survey respondents did not feel banks "are so heavily regulated that they cannot compete effectively...". Only 3 in 10 respondents felt that banks cannot compete effectively under existing regulations. The remaining 20 percent were unsure. To a follow-up question, respondents were asked whether they agree or disagree that if "some banks are having problems with loans to underdeveloped countries or require government assistance to stay in business, would it be a mistake to give all banks additional powers?" About 57 percent of the respondents agreed that it would be a mistake, twice as many disagreed (26 percent); 17 percent of the respondents were not sure.

Respondents were then asked whether or not it would be a good idea for Congress to permit banks to offer services, such as insurance and real estate -- services they were not allowed to offer in the past. In response to this critical question, 50 percent of the respondents said it would not be a good idea, 33 percent felt it would be a good idea, and 17 percent weren't sure. \3

The Reichman survey also provides some interesting insights into why consumers do not support expanded bank services. The main reasons given for opposing expanded bank powers suggests that consumers are uncertain as to whether or not banks have the capabilities to diversify into new business lines and continue to efficiently carry out their basic functions. \4 In other words, consumers feel that an expansion of bank powers could adversely affect the quality of existing bank services. Further, respondents expressed fairly strong concern over the concentration of financial powers in banks. The Reichman study concludes that "the public seems satisfied with banking as it is and, despite a strong minority favoring deregulation, the majority think it might create problems." \5

An analysis by Cambridge Reports, Inc., \6 provides added details as to why consumers may be adverse to bank deregulation. When consumers were asked what they perceive to be the "main disadvantage of deregulating banks", only 12 percent of the respondents said there were "none", and almost half stated that they did not know. Thirty percent of the respondents, however, see very serious disadvantages to bank deregulation. For example, 5 percent of the respondents felt deregulation would lead to banks taking "advantage of" people and 5

percent felt deregulation would confuse consumers. The remaining respondents expressed concerns similar to those found by the Reichman study; 7 percent felt deregulation would lead to "less cautious lending policies" or increased bank failures, 10 percent believed banks would control or raise interest rates and other fees, and 4 percent felt banks were already too powerful.

- One-Stop and One-Source Financial Services

A comprehensive study of consumer support for expanding bank powers was conducted for the Federal Reserve Bank of Atlanta \7. This study concluded that "the data are not conclusive but leave the impression that the general population's current demand for deregulation is not extremely strong." \8

Specifically, the study investigated consumers' support for "one-stop" financial service centers and for financial services from "non-traditional" vendors, e.g. life insurance from banks and brokerage services from banks. The study, which analyzed the results of several surveys and the Bank's own survey (conducted between 1982 through early 1984), found that many consumers expressed broad but shallow support for the concept of one-stop financial service centers. The survey conducted by the Atlanta Fed found that about 50 percent of the respondents indicated that it would be somewhat or highly desirable to obtain all of their financial services at one location. Another 20 percent of the respondents expressed no strong feelings one way or another. However, 30 percent indicated that it was not at all desirable to obtain all services at one location. \9

Although there is some support for one-stop financial service centers, this support does not crossover to consumers wanting a single vendor or one source for all financial services. Consumers prefer having alternative sources for different financial services. Of the 70 percent of the respondents to the Atlanta Fed survey who did not reject one-stop financial shopping, only 28 percent preferred "to get most of their services from a single firm."

In a survey conducted by Fortune magazine of its subscribers, who have relatively high incomes, mixed results were also found. Forty-two percent of the respondents to the Fortune survey stated that they saw "benefits in using one source for most" financial services. However, some of these respondents -- 16 percent -- expressed only slight agreement with this statement. On the other hand, of the 57 percent who did not see "many benefits", 22 percent expressed only slight agreement. \10 The Fortune study concludes that a majority of its respondents need "to be persuaded that the one-stop, comprehensive-source concept has value."

Not only does consumer support for expanded bank product lines and deregulation appear to be relatively weak, it does not seem to be particularly urgent. The Atlanta Fed study concludes that consumers support further bank deregulation and product expansion only for select financial services, and that this support is for "those services they can already obtain from full service depository financial institutions." \11

Other findings from a survey conducted by Payment Systems, Inc., which was reviewed in the Atlanta Fed study, suggest that consumer support for expanded product offerings by banks "represents only the consumer's predisposition to use a service." \12 These findings imply that consumer support, although present, is not definite nor is it urgently needed.

The Atlanta Fed study also suggests that consumer support for financial services continues to be functional in nature, that is, "because of customer loyalty and the desire to obtain a number of different investment perspectives, most U.S. households currently prefer to continue obtaining banking services from banks, insurance from insurance companies, and brokerage services from brokerage firms." \13 This suggests that some consumers envision financial services existing along functional lines and that even if banks provided certain nontraditional services such as insurance, brokerage and real estate, they would likely continue to rely on traditional vendors for these products. The Fortune study provides possible additional insights

> into why some investors do not prefer a single source for their financial services. Over half of the Fortune survey respondents "do not buy" the idea that a single source for financial services would give them a "balanced overall program" of financial management. Fifty-five percent of the respondents also expressed worry about losing control of their financial affairs when using one source for financial advice and services. \14

In summary, the findings from current studies indicate that consumer support for expanded bank business activities and powers is not substantial or particularly urgent. To repeat, the evidence suggests that most consumers today, prefer that financial services be provided along functional lines.

D. LITTLE CONSUMER SUPPORT FOR MUTUAL FUNDS FROM BANKS

The Atlanta Fed study, discussed above, indicates that consumers prefer to receive financial services from sources functionally established to provide them. Do mutual funds fall under this heading? Those who say that they do, argue that "internal mutual funds and other kinds of commingled fund management, currently prohibited to banks, represent a straightforward business extension of current pension fund and other corporate investment management services." \15

The question is, though, do consumers specifically want mutual fund services from banks? The limited amount of research addressing this subject found that a distinct minority of consumers were interested in bank-sponsored mutual funds. A study by Market Facts, Inc. concludes that 20 percent of U.S. households want to buy mutual funds from banks and thrifts. \16

In reality, this estimate is likely to be substantially lower because many of these prospective investors expressed only a predisposition to invest in bank and thrift-sponsored mutual funds. For example, some evidence also exists to suggest that some investors favor banks and thrifts for certain financial services over non-bank vendors because they are more familiar with the former. In a separate Market Facts study of households with annual incomes of $30,000 and above, respondents were asked about their preferences for "savings" institutions. The study found that "non-fund owners have a strong preference for deposit institutions and a lower preference for mutual funds. These preferences probably reflect their greater familiarity with the former types of institutions than the latter". \17 In addition, the lack of familiarity and detailed knowledge of mutual funds, limited cash available for investment purposes, and uncertain

market conditions would all tend to reduce the Market Facts estimate of the number of households that "want to buy" mutual funds from banks and thrift institutions.

E. BENEFITS TO CONSUMERS HAVE BEEN MIXED

Has bank deregulation benefited the consumer or are consumers less satisfied with the financial services being offered by banks? There is evidence, at least in the short-run, that the picture is mixed. Bank services, in many cases, have become less satisfactory to some consumers. The decline in services and consumer benefits are present in several areas:

- Bank Service Costs to Consumers Increase

  A recent survey conducted by the Consumer Federation of America \18 found that since early 1984, bank fees have increased for those services most frequently used by consumers, i.e., passbook savings, checking accounts, NOW accounts, and check return services. The study found that, over the last year, the average cost for passbook savings increased 35 percent, checking accounts increased 5 percent, NOW accounts increased 13 percent, and returned check fees increased 49 percent. During this same period, the consumer price index rose only 3.7 percent.

- Flow of Market Information to Consumers Unchanged

  Bank deregulation has not enhanced the flow of financial information to the public. A survey of subscribers conducted by Business Week magazine found that "only about one-third think that banks and other institutions provide the information needed to take full advantage of the current financial market."\19

  These findings are confirmed for banks by the Reichman survey. According to this survey, customers of commercial banks "feel less satisfied today than in the past" in part because banks have explained their fee and minimum deposit "policies less than other depository institutions." The long-term implications of this may be significant not only for consumers, but also for banks. "Unless commercial banks become much more open with the public about their changing business imperatives and their policies, it is possible that their still-healthy franchise with the American consumer will erode in the future." \20

- Little Added Quality and Expertise From Deregulation

  The evidence suggests that some consumers have not reaped benefits from bank deregulation in terms of the quality of service and product expertise. The quality of bank services in the public's eye does not appear to be uniquely higher than those of other vendors or sources such as Sears. When the Reichman survey asked consumers to compare the "quality of services" at Sears with "other financial institutions such as banks", 55 percent said that the service at Sears is of equal or better quality. \21

  Further, there is some concern over the ability of depository institutions to provide high quality expertise in new lines of business brought on by deregulation. "Among the biggest issues still being debated...is whether savings institutions officials have enough expertise to successfully compete in fields such as real estate development, insurance, discount stock brokerages and commercial and consumer lending." \22

F. EXPANSION OF BANK POWERS: A RESPONSE TO THE NEW ENVIRONMENT

The survey findings reviewed earlier indicate that consumer pressures are not the major factor behind the drive for expanded bank powers and new product lines. If this is so, what are the forces? The answer to this question is to be found in recent trends and changes that have influenced the activities of banks and other types of financial institutions.

For much of the history of the U.S., inflation and interest rates were maintained at relatively low levels. Typically, inflation grew at a rate of 2 or 3 percent per annum and interest rates hovered in the 5 percent range. Starting in the 1970s, however, these trends changed dramatically. Inflation and interest rates rose to double digit levels. To make matters worse, interest rates became extremely volatile. \23

During the seventies, many savers and investors became more aware of these new trends and began to take them into account in their financial decision-making. They more aggressively sought financial products that paid both a market return and offered a measure of protection against the erosion of their savings. Their shifting demands for financial products forced the regulatory authorities to modify longstanding rules and regulations in order to allow the financial system to adapt to the new environment.

The banking industry adjusted to the new financial environment largely with the help of deregulation. Not only was deregulation seen as a means to acquire added deposits, but "savings industry officials contend that diversification will provide much needed alternative income sources." \24 The expansion of bank powers, largely a result of the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA), helped change the operating guidelines for banks and allowed them to become more rate competitive.\25

The DIDMCA focused on easing interest rate restrictions and broadening product lines. Bank activities under the Act have included the phasing-out of interest rate ceilings under Regulation Q, the establishment of MMDAs and super NOW accounts and the removal of minimum CD balance requirements. All of these actions were designed to provide banks with the ability to attract the deposits necessary to carry out their "core" lending functions.

The banking industry has taken advantage of the new opportunities made available from recent regulatory changes by expanding their product lines. But bank product line expansion raises the possibility of associated risks. Although only limited data are available for the banking industry, studies for other industries "reflects business behavior and may be suggestive" of implications for the banking industry. "Experience with product line expansion, i.e., diversification...suggests that for at least some firms there is a significant risk associated with such expansion." \26

G. Summary

The findings reviewed in this report may be best summarized by the following direct quote:

> "...consumer demand for product deregulation is unlike the demand for interest-rate deregulation. The demand to earn higher interest rates was a compelling enough force to make consumers redirect their funds to the new types of institutions offering money-market rates. With product deregulation, however, there is a gap between what consumers say they will do when broader product choices are offered and what they say they will do when they consider using non-traditional vendors. It is doubtful that convenience alone will cause large numbers of consumers to consolidate their services if financial products are deregulated in the future..."\27

FOOTNOTES

\1 Reichman Research, Inc., "An Opinion Survey: The American Public's View of Current Banking and Financial Issues," October, 1984, p. 4.
\2 Reichman, p. 6.
\3 Reichman, p. 11-13.
\4 Gross, Laura, "Half of Public Opposes Broadening of Commercial Bank Powers" in American Banker, October 20, 1984.
\5 Reichman, p. 13.
\6 Cambridge Reports, Inc., Quarterly Opinion Review, First Quarter, 1984.
\7 Bennett, Veronica, "Consumer Demand for Product Deregulation" in Economic Review, Vol LXIX No. 5, May 1984, published by the Federal Reserve Bank of Atlanta.
\8 Bennett, p. 36-37.
\9 Bennett, p. 30.
\10 Belknap Data Solutions, Ltd., "The New World of Personal Financial Services", published by Fortune, 1983, p. 3.
\11 Bennett, p. 36.
\12 Payments Systems, Inc., Payments Systems Perspectives '83: A Special Report, Vol 1, July 1983.
\13 Bennett, p. 29.
\14 Belknap, pp. 3-4.
\15 Stone, Bernell K., "Business and Bank Reaction to New Securities Powers" in Economic Review, Vol LXIX, No. 5, May 1984, published by Federal Reserve Bank of Atlanta, p. 48.
\16 Market Facts, Inc., "Banks and Thrift Mutual Funds: An Emerging $40 Billion Market", 1984, p. 1.
\17 Market Facts, Inc., "Survey of Consumer Needs and Preferences", for the Investment Company Institute, August 1983, p. 85.
\18 Fox, Alan, et al., Bank Fees on Consumer Accounts: The Second Annual National Survey, for Consumer Federation of America, May 1984.
\19 "Few Believe Financial Institutions Offer Enough Market Information", in Bankers News Weekly, April 2, 1985.
\20 Gross, Laura, "New Poll Looks at Consumer Attitudes on Changing Financial Service World" in American Banker, October 20, 1984.
\21 Gross.
\22 "S&L's Search for Right Businesses on the Risky Road to Diversification," in Investor's Daily, January 2, 1985.
\23 For a complete discussion of the events affecting banks during this period see: Beede, Jack, "Bank Stock Performance Since the 1970's" in Economic Review, No. 1, Winter 1985, published by the Federal Reserve Bank of San Francisco.
\24 Investor's Daily.
\25 Watro, Paul R., "Deposit Rates and Local Markets" in Economic Commentary, February 15, 1985, published by the Federal Reserve Bank of Cleveland, p. 1.
\26 Rhoades, Stephen A., "Interstate Banking and Product Line Deregulation from Available Evidence", 1984, unpublished paper, p. 58.
\27 Bennett, p. 37.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. It's gone a lot longer than I expected. I am under a time restraint, but I did want to hear Mr. Silver's testimony. I have to leave.

The CHAIRMAN. I was checking to see if Senator Riegle was coming back. I thought he wanted to question you before catching a plane, and when you came back, you apparently are going to catch a later one.

Mr. SHAPIRO. I appreciate your consideration, but we do want to participate to the extent that we can.

We don't get all that many opportunities, as you are well aware.

The CHAIRMAN. Well, I hope you don't have too many more from anybody else on that matter.

Let me just make one final point. Again, I don't know why I keep trying to convince some segments either about the overall general fairness issue, but I will try once more by reading directly from Glass-Steagall, because you made a point that is not often made, and I'll make one that I don't make nearly often enough.

GLASS-STEAGALL IS A TWO-EDGED SWORD

Glass-Steagall is a two-edged sword. All that was developed to prohibit banks from entering into the securities business and general commerce. It also says, and I quote:

> It shall be unlawful for any person, firm, corporation, association, business, trust or other similar organization engaged in the business of issuing, underwriting, selling, or distributing in wholesale or retail or to syndicate participation, stocks, bonds, debentures, notes or other securities, to engage at the same time to any extent whatsoever, in the business of receiving deposits, subject to check or to repayment upon presentation of a passbook.

Now I know what's going to be said—you're not taking deposits. There we get into another loophole. That is correct, you are not taking deposits from the nonbank banks, or you're not in commercial loans, one or the other. We can play with the legal niceties, but it gets into that third-party payment thing that I have been mentioning about so clearly. I don't know how anybody could look at this and not understand the intent of Glass-Steagall on both sides—on both sides of the issue.

On the one hand, we have played a nonbank bank loophole on this provision, and you can legally say and be on solid legal ground, that we are not taking deposits, therefore, that prohibition doesn't apply to us. But the spirit of fairness and equity in stopping that cross-polarization of both directions should be evident to everyone.

That really is where I come down, without regard to any of the individual powers that we are seeing take place in the marketplace, without any direction from Congress and the securities and insurance industry, particularly, with some exceptions, coming in and saying you keep banks back with Glass-Steagall, but don't hold us to the spirit of the law.

That's what disappoints me in your testimony. Mr. Silver.

Mr. SILVER. Mr. Chairman I think that perhaps in the long run, we have crossed a broad Rubicon, and a significant restructuring which will lead to a very different kind of financial services system than we have today may result from it.

You and I probably both share the view that this might not be a good idea, but it may happen in the long run. The point is, though, that meanwhile we have a kind of seesaw. One side manages to unbalance it and the other side wants to add some weight to its side to redress the balance.

The Glass-Steagall Act was the basis for regulation Q. So Glass-Steagall did two things. It separated the two industries and it put interest rate ceilings on deposits coupled with insurance. In 1980 or 1981, when I testified before you, you said to me, Would it be better for the public interest to give banks money market funds or to repeal regulation Q?"

I swallowed very hard, because I knew that that was Scylla and Charybdis, and you were forcing me to one or the other. But I said, and I believed, that probably the sounder public interest course was to repeal regulation Q.

We haven't recovered from the repeal of regulation Q to this day. Money market funds were $235 billion in December 1983 when regulation Q was lifted. We have just now recovered to around the $200 billion mark, for all money market funds, and about $170 billion in consumer-oriented money market funds.

So you forced me to the choice in 1980. We made it, and you made it, and the banks have the insured money market deposit accounts, and we have the money market funds. That certainly redressed an imbalance at that point.

But I'm astounded when I read the testimony not only of the bankers but of some who share some of the views that I espouse—and I agree with the frustration that you have expressed—how can people come in and reasonably say: "Close the nonbank banks because we don't want competition from the securities business in banking, but give us the additional securities powers."

It seems to me that that's not only removing weights from one side of the teetertotter, that's adding a lot of weight on the other side. As long as we are engaged in the process of really trying to fine-tune—and I understand that last year's bill was, from your point of view, really fine-tuning and did not represent the major restructuring that may have to occur in the long run—the question then becomes one of whether you're moving too much weight from one side and adding too much weight to the other.

Mr. SHAPIRO. David, if I may add, it is true, we of the securities industry do not have banking powers, which I know you will agree, we do not have access to the Fed window. We cannot take deposits and have them federally insured. We do not have trust powers. It is absolutely true that we have worked with banks—Merrill Bank 1, which I cited earlier—where we have collaborated with a bank, as defined, which doesn't have those powers to see to it that a service would be provided. But this industry does not have and never has had bank powers.

The CHAIRMAN. Well, I think you're playing games with me again. You don't have full banking powers.

Mr. SHAPIRO. We certainly don't.

The CHAIRMAN. Of course you don't. But, under some of these interpretations of the law, you do have—and I'll use the term that's been used with me—bank-like powers. You're not a commercial bank. Nobody has ever said that. I have never said that, that they are full, or even close to full, service banks. Even all banks are not full service banks.

But there has been engagement in banking-like services overwhelmingly. There are very few people that won't admit banking-like services when I change it to that, rather than being a full commercial bank under the law.

You are not. I just don't see any way out of this because what I continue to hear, with a few exceptions, is the bankers come in asking for the world and that's where, David, my bill is very moderate compared to what they want at the banks.

You would think from today that I am totally antisecurities and totally probanks. But you know what they want. They have never gotten one-tenth of what they want out of this committee. That's what I'm hearing. They want the world; you don't want them to have a little piece and so we go on and on, year after year, and then we hear about safety and soundness and let's consider it on a comprehensive measure.

Mr. SHAPIRO. Isn't it true that there are really very few banks that do want the world? Some do, I grant you, but, certainly, the banks to which you refer, which used to be involved specifically in real estate activities, they're not asking for the world.

The CHAIRMAN. Well, I'll revert back to one of your answers. How do you define few? How many numbers? There are probably not as many as I think, or a lot more than I think.

Mr. SHAPIRO. That could very well be, but I guess this industry views that when Citicorp, in particular, or Bank of America, or whoever, of that ilk and of that size wishes to have the world, that this industry individually and collectively fundamentally won't be competitive. That may or may not be what Congress decides is in the best interest of the country.

We don't think it is and we don't believe Congress should. We recognize it's a possibility, but I think, in the very macrosense, Senator, it can come down to just that. Now I don't know that each of us individually would be disadvantaged per se, but we're not focusing on that. We're talking about not just today but tomorrow and 10, 20, and umpty-ump years from now, and that is why we do feel as firmly as I hope I have been able to express about this issue, and we think it is a macroissue. It is not a mini-issue in any way, shape or form.

I think the specifics really pale compared to what the subject itself implies and what we're talking about for many years to come.

You haven't heard it before but——

The CHAIRMAN. Well, you know, it's interesting. Maybe I've been around here too long, too naive. I used to think it was possible to get some order and sense and everybody being at least a little bit realistic. But you know what's going to happen, we're not going to have comprehensive legislation. I mean, real comprehensive legislation out of the body of Congress. That's not going to happen.

Why should it happen in the banking field if it doesn't happen in any other area? When did you ever see Congress look 5 or 10 years down the road. When I was a mayor, I could do that. You know, I could make some decisions on capital improvements and say what the city is going to look like 10 years down the road, and get in trouble because people wanted to do things daily.

But Congress will basically respond to what they think helps them politically before November 1986, at this particular time. And as good as it sounds to say let's look at it in the big package, and that's the way I started out, it keeps narrowing down to little pieces and let's go back and call it salami, whatever, it really doesn't make any difference.

And that's what you're going to see. You're going to see the marketplace way ahead. I may be successful in getting another bill through this year; I may not. I may get another one through in another couple of years or something and it will be piecemeal because I'm only 1 out of 100. And I don't have enough persuasive powers to force this body to take a comprehensive look at the whole system and make some decisions over a longer period of time.

They won't do it and I guess I should quit kidding myself except I'm not the type of personality who will just sit back and flow with the world. I will keep trying. I'll keep beating my head against the pole. Without regard to any individual decisions, as with David, who probably knows me as well as anybody, I don't have any great bias to a particular decision.

The closest one that comes is municipal revenue bonds, and that's a bias that comes from my dealings as a mayor when I had to finance projects that I would have saved my taxpayers some money if there had been some more competition.

But other than that one, I don't feel terribly strongly about any provisions one side or another, although I may appear to be at some times.

ATTEMPT TO BE A CATALYST

I really attempt to try to be a catalyst, to bring hundreds of people over the years to listen to all of them to try and get them to talk to each other like on some of the real estate decisions, getting all of these groups together, 11 different organizations saying, hey, give a little bit for the good of everybody, hoping I can produce legislation that everybody would come in holding their nose and saying I really don't like it but I'll accept it.

And then you would feel you had a pretty well-balanced piece of legislation if nobody really liked it. And that's true. If the bankers came in and told me this is a wonderful bill, I'd say, boy, something is wrong with it. A few people came in and said it's just what we want, it obviously would be biased in your favor.

So I walk a very difficult tightrope and at one time or another I get accused by every group. I have succeeded in making every segment of the financial services industry mad at me at one time or another.

So my frustration comes from a more general standpoint. Just what you're talking about is exactly what I'd like to do, not only in these issues but in a lot of others have Congress take a longer view

than take a short-term political decision from defense to financial institutions.

The defense debate is primarily now over domestic politics and which side looks best. Don't analyze the needs of the country in defense and talk about $600 toilet seats. Nobody would agree that a toilet seat is worth that much, but I don't know. I guess I'm getting frustrated with the whole Congress as an institution.

It becomes more and more politicized all the time, has more fun playing for the cameras than anything else and how do I look at home with my press releases than sitting down and trying to rationalize a system that we all agree is evolving and changing very rapidly in a revolutionary state, and years go by and we play legislation by loophole.

I don't know.

Mr. SHAPIRO. I don't take any issue with what you say as citizen John Doe. I guess it is frustrating. I guess, not being beaten, as I'm sure you have been, I can't help but retain some of the idealistic focus.

The CHAIRMAN. See, I have the advantage. I don't get beaten up very badly after what I took from Gary Troudeau, and so on, for 4 or 5 months. [Laughter.]

And others. And I enjoyed every minute of it and the flight was worth all that guff I had to take. [Laughter.]

Mr. SHAPIRO. But I can't help but mention civil rights legislation, which truly was as far-reaching as any piece of legislation could be and necessarily so.

And, there, to the credit of Congress, it dealt with that issue, not an easy one; far, far from it. Really, much more complex in so many respects politically than what we are discussing this morning.

But I guess I am an optimist and I am somewhat of an idealist and I think it is still possible. And I, therefore, I guess hope for whatever comes——

The CHAIRMAN. So am I. I just don't expect to still be here any more.

Mr. SHAPIRO. Well, maybe we'll both be pleasantly surprised.

The CHAIRMAN. When it takes place.

I have no further questions.

Do either of you have any final comments you want to make?

Mr. SHAPIRO. Michael, would you like to—if you have just a moment, you referred to the revenue bond sector. Mike Hernandez, happily, is an expert in this area and I am not. And if you have a moment, there are some statistics that I think would be meaningful.

May we have that opportunity?

[The following was subsequently submitted for the record:]

LETTERS OF CREDIT
AND
UNFAIR BANK ADVANTAGE IN UNDERWRITING

In 1982 before the Subcommittee on Securities of this Committee SIA presented the results of some original research which showed that the use of letters of credit in connection with underwritings was on the increase and that some banks had apparently taken unfair advantage of their position as credit suppliers to leverage themselves into management positions in underwriting groups for bank-eligible revenue bonds. (Hearings before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate (97th Congress, Second Session) on S. 1720 [Report 97-47, pp. 438-466, esp. 457-466; also see pp. 138-139]) Letter of credit (LOC) volume in 1980 was only $100 million, but grew to $4.7 billion in 1981 and to $13.9 billion in 1984.

SIA had tracked three major banks in 1981 and found that in 24 mortgage bond issues in which one of them served as a manager, the bank had offered a letter of credit or other credit enhancement: 24 out of 24. SIA pointed out that banks had not been very successful in selling themselves as managers on an even competitive basis in earlier years when credit enhancements were not significant. However, particularly in times of high interest, the unique ability of banks to provide letters of credit gave them the unfair advantage of offering a LOC to obtain a place in the management group. SIA pointed out that existing tying restrictions in the law were inadequate to deal with these unfair situations, because no large, sophisticated bank was stupid enough to speak about a quid pro quo, but the pressure and unfair advantage were nonetheless there.

SIA decided to track the same three banks in a subsequent year and picked the most recent year available, 1984. The three banks supplied letters of credit 28 times out of the 36 occasions in which they served as underwriting managers--78% of the time.

It is clear that the LOC is an incredibly valuable and unique tool for a bank to use to get itself into a management group. This is a very real example of unfair bank advantage that is growing in the bank-eligible revenue bond market today. Other banks are now doing the same thing in increasing numbers. S. 2851 did not deal with the problem.

Summary
1984

Security Pacific:

Supplied letter of credit for 18 of the 19 issues for which it acted as a manager. (In the 19th, Citibank supplied the letter of credit for a Security Pacific client for which Security Pacific had three times that year already provided the LOC and acted as a manager.)

Citibank:

Supplied letter of credit for six of the nine issues for which it acted as a manager.

Chemical:

Supplied letter of credit for four of the eight issues for which it acted as a manager. (In one of the other deals Citibank supplied the LOC.)

SECURITIES INDUSTRY ASSOCIATION
June 20, 1984

1202f

The CHAIRMAN. Well, until the bells ring. My staff has just reminded me, and I didn't even notice, that there is a vote going on. So until five bells ring, I will listen.

Mr. SHAPIRO. If not, we will be pleased to submit the remainder for the record.

The CHAIRMAN. In fact, maybe that's what we'd better do if you don't mind, if you would submit it for the record. I was so intent on listening to myself, I didn't notice the vote was going on. And I think maybe I'd better start over to the floor.

Mr. SHAPIRO. If we may have that option.

[Additional material supplied for the record from Mr. Shapiro and response to Senator Garn's written questions to Mr. Silver follow:]

THE BANKING AND SECURITIES INDUSTRIES:
A CASE FOR MAINTAINING THE FUNDAMENTAL SEPARATION

Securities Industry Association

New York

Washington

1985

Introduction

The commercial banking industry and the securities industry each play a vital role in our nation's financial system. That system -- the product of thoughtful and consistent Congressional policy articulated and reaffirmed repeatedly over the past half century -- is based on the separation of the banking and securities industries. The Securities Industry Association ("SIA") believes the principles of the Glass-Steagall Act -- the Bank Act of 1933, which separated commercial and investment banking -- remain valid today. This paper summarizes the major arguments against eliminating the Glass-Steagall wall; arguments advanced by several money-center banks in their quest to enter the securities industry.

Executive Summary

Ostensibly pursuing bank "deregulation," two large money-center banks recently produced lengthy advocacy papers arguing for the repeal or revamping of the Bank Act of 1933, known popularly as the Glass-Steagall Act.[1] Repeal of the Act would permit banks to expand into all phases of the securities business. In addition, the banks have requested real estate and insurance powers.

Since passage of the Act, banks have tried to obtain securities underwriting powers on several occasions. Their recent arguments, however, contain a new twist; they claim the Glass-Steagall Act not only is outdated, but that its enactment by Congress was a mistake. This paper will review why Congress indeed was correct in enacting Glass-Steagall and why banks, for the following reasons, should not be granted expanded powers:

-- The banking system currently is too fragile, and investor confidence too shaky, to permit banks to enter new businesses, especially those as risky as the securities business.

-- Banks, as a matter of long-standing national policy, were and are considered to be "special." To carry out that role they are provided unique federal advantages, such as favorable tax treatment, unique credit privileges, and deposit insurance. Because of their special role in our economic system, banks should be confined to banking and should not be authorized to engage in general commerce.

-- During the six-years that banks were permitted to underwrite securities (1927-1933), many abuses occurred. These, in fact, led to the passage of the Glass-Steagall Act. Such abuses, albeit in more modern guises, would recur if banks were to expand their activities into the securities industry.

-- Bank allegations that the securities industry is uncompetitive and excessively profitable are false. Negotiated rates and accelerated securities registrations are but two forces that have led to an intensely competitive securities industry. In the past ten years, competition has produced a consolidation of firms while spawning many new entrants. Moreover, profitability in the securities industry is much more volatile than in banking. Such volatility would endanger public confidence in the banking system.

SIA is aware of the current blurring of the traditional lines among financial intermediaries. The Association also recognizes the concerns of Congress and the Administration for a safe, sound, and economically viable financial services sector that protects savers, facilitates investment, and ensures the greatest possible access to capital. The American system of separating the investment and commercial banking functions has proven spectacularly productive. In fact, much of the current confusion concerning the roles of the commercial banking and securities industries arises from the innovations each sphere has made in the delivery of a wide range of services to its customers.

SIA believes the elimination of Glass-Steagall would not bring with it the benefits envisioned by large money-center banks. Eliminating the Act would result in inadequate customer protection, increased concentration of financial power and a movement toward European-style universal banking, with its bias against entrepreneurialism. But SIA agrees with the banking industry that a comprehensive review of current law is in order. Moreover, SIA has called for a review of the Glass-Steagall Act and other relevant banking legislation for more than a decade. With appropriate safeguards, in fact, (See Appendix A) bank entry into the securities industry may be possible. At the conclusion of a comprehensive Congressional review of the law, SIA believes Glass-Steagall protections will be strengthened, not removed.

The Current Fragility of the Banking System

A stable banking system rests on two bases: the making of prudent and disinterested loans and investments and the continued confidence of depositors. Problems in each of these areas contribute to the current fragility of the U.S. banking system; expanding bank powers only would strain a system that already has endured significant stress.

Problems in Lending

Prudent lending is the bedrock of commercial banking. It is a bank's critical function to make loan and investment decisions solely on the basis of the financial soundness of each transaction. Recently, the lending policies of the commercial banking industry have led to systemic weaknesses.

Foreign Loan Crisis

U. S. banks have approximately $100 billion at stake in loans to foreign countries, including $26.3 billion to Mexico, $20.7 billion to Brazil, $11.3 billion to Venezuela, and $8.5 billion to Argentina. Many of these loans are held by just a few of the nation's big banks. For example, Manufacturers Hanover Trust alone holds $1.3 billion in Argentina's debts. An outright default by Argentina would wipe out two-fifths of the bank's equity capital.[2]

Every few months, a foreign debt crisis looms, and some arrangement is made to defer current interest due, to reschedule loans, or to obtain International Monetary Fund credit. This continuing saga has been described by Newsweek as a "soap opera," in which "it doesn't seem to matter when you tune in on the debt crisis -- all the basic problems remain the same."[3] Noting that many large American banks are taking great risks with foreign loans, Newsweek observes "the melodrama may turn to tragedy before it ends."[4]

Continental Illinois National Bank Failure

In May of 1984, Continental Illinois National Bank -- the nation's eighth largest -- almost failed, due in part to bad energy loans. What prevented total collapse was an unprecedented $4.5 billion rescue package put together by federal bank regulators. The New York Times succinctly conveyed the message of this act: "The Government will step in with Federal money, backed by the power of the Federal Reserve rather than allow a big bank to fail...."[5] Former Treasury Secretary Donald T. Regan said at the time, "we will make sure that there are no calamities in the banking system."[6] No other competitor in the financial services marketplace has this assurance of a massive federal safety net to subsidize its bad judgment.

Failures Throughout the Banking Industry

In the past two years, 127 banks have failed.[7] Appendices B and C chronicle this phenomenon, listing every bank by state that failed in 1983 and 1984. The most recent two year period has witnessed the greatest number of bank failures since the Great Depression. Almost 1,000 other banks are considered "problem banks" by the FDIC.[8] In the midst of these widespread failures, the expansion of bank powers is both implausible and irresponsible.

Savings and Loan Failures

In addition to banks, many of the nation's thrift institutions also are in danger. Edwin T. Gray, chairman of both the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (FHLBB), told a House Subcommittee that up to 10 percent of the nation's savings and loans are in "severe trouble" and that between 250 and 300 S&Ls are on the FHLBB's "trouble list."[9] More startling, he said that "even tripling insurance premiums to boost the FSLIC fund by $1 billion would be insufficient to cover expected failures."[10] The FSLIC lost money in 1984 and its usable assets of $4.7 billion must insure deposits more than 200 times as great.[11] One major California thrift has collapsed already in 1985. According to The New York Times, many more are expected to follow.[12]

Dangers of Securities-Related Lending

The conflicts of interest that arise when banks engage in securities-related ventures severely undermine a bank's ability to continue making disinterested banking decisions.[13]

As an example, at the height of activity in real estate investment trusts (REITs) in the early 1970s, it was a common bank practice to extend loans to a REIT which also received investment advisory services and sponsorship from the bank or its affiliate.[14] Indeed, the losses suffered by Chase Manhattan Bank, N.A. during the 1970s in the protracted decline and ultimate collapse of its REIT painfully demonstrated how such conflicts help put the nation's third largest bank on the "problem bank" list of the Comptroller of the Currency. Although outstanding REIT loans have decreased with the passage of time and the decline of the real estate investment trust industry,[15] the once serious problem illustrates the dangerous temptations to which banks may succumb in promoting securities services.[16] Some current examples of these conflicts follow.

Bank Mortgage-Backed Securities Scandals

In recent years, many banking institutions have shown interest in floating privately created mortgage-backed securities. Bank of America alone, for example, issued at least $900 million worth of securities backed by its own

mortgages between 1977 and February 1985.[17] Yet Bank of America and Wells Fargo Bank were racked with scandal when appraisals on particular real estate properties -- the ultimate collateral for the mortgage-backed securities -- were found to be grossly inflated. Bank of America was forced to buy back securities it had issued for $133 million but which had plummeted in value to close to $38 million. This forced Bank of America to take a $95 million pre-tax write off against its 1984 fourth quarter earnings. Many of these securities were sold to thrifts and other financial institutions that also sustained substantial losses.

The dangers of securities-related lending are not limited to mortgage-backed securities or REITs. Should an issuer for whom a bank has effected a private placement, for example, find itself in unexpected financial difficulty, the bank may feel obliged to extend a loan which otherwise might not conform to its normal credit standards. By doing so, it would seek to avoid the understandable embarrassment and damage to its reputation among institutions that had purchased the offering, or the possibility of litigation under the securities laws.

Banks involved in an unsuccessful sale of commercial paper, to cite another example, may be forced for competitive reasons to make a loan in the amount of paper unable to be placed. This could result in an allocation of the bank's assets to issuers whose credit is the most difficult to place,

i.e., those whose paper is least acceptable to buyers of commercial paper. Currently, three large banks are engaged in the sale of commercial paper, although the legal status of this activity remains questionable.

The Glass-Steagall Act deals directly with these problems. As the Supreme Court recently observed in ruling that commercial paper is a "security" subject to the Act's prohibition on bank underwriting:

> Congress also expressed concern that the involvement of a commercial bank in particular securities could compromise the objectivity of the bank's lending operations. Congress feared that the pressure to dispose of an issue of securities successfully might lead a bank to use its credit facilities to shore up a company whose securities the bank sought to distribute. [Citation omitted.] Some in Congress feared that a bank might even make unsound loans to companies in whose securities the bank has a stake or to a purchaser of securities that the bank seeks to distribute. [Citation omitted.] Alternatively, a bank with loans outstanding to a company might encourage the company to issue securities through the bank's distribution system in order to obtain the funds needed to repay bank loans. [Citation omitted.] Congress also faced some evidence that banks had misused their trust departments to unload excessive holdings of undesirable securities. [Citation omitted.][18]

The ability of banks to make prudent and disinterested loans is as important today as it was in 1933. Clearly, the expansion of bank powers to include securities underwriting would jeopardize adherence to this vital banking principle.

Confidence in the Banking System

The second key element of bank stability is depositor

confidence. There is ample evidence that any serious loss of public confidence in the banking system could lead to bank runs, a credit contraction, and the possibility of bank failures. Several recent events underscore the crucial role of depositor confidence to the healthy functioning of the banking system.

The Ohio Thrift Crisis

One need only look at photographs of depositors lined up outside Ohio savings and loan associations in the spring of 1985 to realize that bank runs did not end in the 1930s.[19] The current crisis was brought about by thrifts which had risked their depositors' money in the government securities market. Using repurchase agreements to seek higher returns and to skirt loan limits, the thrifts were besieged after the failure of a small, unregulated dealer, E.S.M. Securities, in March 1985. The collapse brought down Cincinnati's Home State Savings Bank, a $150 million E.S.M. investor. Panic then spread throughout Ohio, as Home State's failure threatened to exhaust the state's $130 million private insurance fund, which covers deposits at 70 of Ohio's nearly 300 savings and loans. More than 1,000 people camped overnight in front of these S&Ls, hoping to claim their money before it was gone.

Ohio Governor Richard Celeste ordered all privately insured thrifts in the state to close -- the most widespread financial shutdown since President Roosevelt declared a

one-week national bank holiday in 1933. Although the immediate danger of a wider panic subsided when the Federal government said it would intervene -- further evidence of banks' special treatment by the government -- the uneasiness in Ohio rattled savers across the nation and worried foreign investors as well. Time magazine reported that "in a classic sign of anxiety," the price of gold shot up by $35.70 in one day at the height of the panic. "At the same time," Time reports, "a rocketing dollar took a nose dive as traders fretted about the stability of the U. S. banking system and the strength of the economy."[20]

The Ohio scenario was repeated just two months later in Maryland, where a bank whose problems touched off a crisis had been charged with numerous violations of state banking regulations. Old Court Savings and Loan had millions of dollars in unsecured overdrawn accounts to officers and directors, and millions more in loans on properties in which it also held an interest.[21] Again, federal insurance was the ultimate rescuer for depositors. As The Washington Post editorialized:

> High interest rates, and the deregulation of the interest rates that banks and S&Ls can pay their depositors have turned consumer finance into a game of substantial risk and extraordinary complexity...The sad story of the Ohio S&Ls is another warning that any furthur deregulation of the financial institutions needs to be approached with extreme caution -- and in some areas re-regulation is worth considering."[22]

The Ohio and Maryland panics illustrate two truths about current banking practices: first, some banks are willing to take excessive risks at the expense of their customers (who must then be bailed out by insurers); and, second, the well of depositor confidence may be running dry.

Farm Bank Crises

The financial plight of America's family-owned farms is testing depositor confidence as well. Of the nation's 15 banks that failed during the first two months of 1985, more than half were "farm banks" -- those 4,000 plus institutions which do more than 25% of their lending to the farm industry. Additional casualties are expected.[23] Mismanagement and insider abuse were the main causes for the 28 agricultural bank failures during 1984 and the first month of 1985.[24]

Energy Related Problems

In Texas, depressed oil prices and a glutted real estate market have had a dramatic impact. The Wall Street Journal reports that "just three years after energy lending turned into the biggest bust since the Great Depression, a second wave of financial problems is rocking big Texas energy lenders, portending more serious losses at even the strongest banks."[25]

The seriousness of these banks' problems is illustrated by the crackdown by federal regulators in requiring

the banks to adopt more conservative accounting practices and more stringent criteria for evaluating loan collateral. Examiners of the Comptroller of the Currency, who "have pitched tents in Houston and Dallas," have found that even usually highly-rated Texas Commerce Bank had a bare-bones reserve of just 1.13% of total loans at the end of 1984.[26]

Bank Fraud Increasing

The FBI recently reported that the incidence of bank fraud cases involving more than $100,000 has doubled since 1981. The Bureau currently has 8,000 such cases pending.[27]

In response to this increasing incidence of illegal activity, Attorney General Edwin Meese has announced plans for a multi-agency attack by all bank regulating bodies against bank fraud. Meese stated that bank fraud "seriously undermines the confidence and trust that individuals and businesses place in the banking industry as a whole."[28] Beside eroding public confidence, bank fraud appears to be at least partly responsible for the dramatic rise in bank failures. According to a Justice Department survey of 75 FDIC-insured banks that failed between 1980 and 1983, 61 percent involved "actual or probable misconduct by bank insiders."[29] Moreover, the chairman of the FDIC recently stated that at least half of the recent bank failures are "attributable to fraud and insider abuse."[30]

Conclusions

Given the ample evidence that today's banking environment is fraught with risk, it would be foolhardy to suggest, as a handful of money-center banks do, that granting banks additional powers in the securities industry would somehow lessen their exposure. Moreover, permitting banks to expand into areas of general commerce calls into question their very uniqueness. As the Federal Reserve Bank of Minneapolis said in its 1982 annual report: "If anything, concerns regarding financial concentration, conflicts of interest, and the fiduciary responsibilities associated with lending depositors' money may be more relevant today than they were 50 years ago."[31]

These themes, as well as a commitment to a reduction in the costs of intermediation, have been at the center of banking legislation and regulation over the past fifty years.

The Government-Granted Advantages of Banks

Financial intermediation by banks involves the accumulation of savings as deposits and the lending of these funds to those with capital needs. Banks enjoy federal subsidies of the two basic cost elements in intermediation -- a rate of return sufficient to induce holders of excess funds to deposit them, as well as the cost of the intermediation process itself -- so that those who need funds may obtain them relatively inexpensively.

For example, federal deposit insurance serves to lower the rates of return required to attract depositors. Deposit insurance makes bank deposits up to prescribed levels virtually "risk free." Depositors in any federally-insured institution are guaranteed absolutely against losses up to $100,000, a guarantee backed ultimately by Congressional appropriation power. Moreover, as the Continental Illinois debacle graphically illustrated, the Federal government will not permit a major money-center bank to fail. Because of the catastrophic consequences such a failure would have on the entire financial system, holders of nominally "uninsured" deposits in these institutions are effectively fully guaranteed by virtue of the "too big to fail" phenomenon. Federal insurance -- specified to $100,000 and implied at least for large banks beyond that amount -- constitutes a specific cost-savings advantage that banks alone enjoy.

In addition, banks have ready access to short-term capital at low cost through the federal funds market and the Fed's discount window. The cost to banks of long-term capital also is lower because of reduced risks associated with investment in the banking business. Such reductions in risk result in part from the readiness of the Fed to provide low cost credit through the discount window to meet banks' temporary liquidity problems.

The direct costs of intermediation are reduced further through the favorable tax treatment accorded banks for certain interest expenses and loan loss reserves[32] which increase their after-tax income. As a result, the effective corporate income tax rate paid by banks is among the lowest of all American industries. The Joint Committee on Taxation has found that commercial banks paid an effective income tax of just 2 percent in 1981, as compared with 48 percent for the automobile industry, 46 percent for the trucking industry, 36 percent for the pharmaceutical industry -- and 17 per cent for diversified financial companies.[33]

Banking Subsidies

Economists would classify these special advantages and privileges -- tax breaks, deposit insurance, and access to the discount window and the federal funds markets -- as "subsidies", the purpose of which is to lower the cost of intermediation and thus, presumably, lower the cost of funds to

borrowers. These subsidies are paid for directly or indirectly by the public.

Subsidies are provided to banks in the expectation that the savings will be passed on to borrowers of funds, thereby reducing borrowing costs, making credit more freely available and stimulating economic growth. To employ these subsidies in securities or other non-banking activities would constitute a clear departure from national policy.

Non-banking entities facing competition from bank affiliates in nonbanking areas have real cause for concern that the affiliates would enjoy an unfair competitive advantage. Banks can and do extend credit to their affiliates in amounts and on terms that other firms could never secure. To reassure the Congress and regulators that nonbank affiliates would not enjoy an unfair advantage, bankers frequently cite Section 23A of the Federal Reserve Act,[34] which generally is intended to require adequate collateralization of loans by member banks to their affiliates. But Section 23A, which was "liberalized" by the "Banking Affiliates Act of 1982,"[35] is hardly even a mild restraint on bank loans to affiliates.

First, transactions between a bank and its majority-owned non-bank subsidiaries are not even "covered transactions" subject to Section 23A. Second, many transactions that otherwise would be "covered transactions" are expressly exempted; for example, a bank loan to an affiliate that is fully secured by U.S. Government obligations. Third,

the quantitative limitations on covered transactions -- 10% of a bank's capital stock and surplus on credits to any single affiliate and 20% on credits to all affiliates -- are far from onerous. As an article by staff of the Federal Reserve Board candidly acknowledges, the 1982 "liberalization" did not address the quantitative limits because "they did not seem unduly restrictive, as evidenced by a lack of agitation by bankers for higher limits."[36]

A few current examples drive this point home. Based on their respective 1984 annual reports, a major New York bank had authority under Section 23A to lend $278,880,000 in covered transactions with affiliates[37], while a major California bank had authority to lend $434,618,400.[38]

It must be noted as well that Section 23A does not in any way restrict loans by a bank holding company to its nonbank subsidiaries of funds derived from dividends of its banking subsidiary. Nor does it regulate interest charges on covered transactions.

In short, the mere fact that a loan to a nonbanking affiliate may be adequately collateralized, or funded by bank dividends, is little comfort to a competitor of the affiliate. Section 23A may reduce the risk of a bank failure, but it does not redress the inequity of bank affiliates having access to loans on preferential terms.

Other Competitive Advantages of Banks

In addition to inherent cost advantages, the banks' permissive regulatory structure and their unique customer relationships would give bank securities affiliates unparalleled competitive advantages.

Bankers frequently claim that the body of securities regulations developed over the past 50 years justifies the elimination of Glass-Steagall. What this contention conveniently fails to acknowledge is that banks enjoy broad exemption from a major portion of these securities laws and regulations -- and are unwilling to see this exemption diminished in any way.

Section 3(a)(4) of the Securities Exchange Act of 1934 (the "1934 Act") defines the term "broker" to mean "any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." (Emphasis added.) This statutory exclusion was based on the Congressional understanding that banks generally were prohibited from engaging in the securities business under the Glass-Steagall Act. Those who are classified as "brokers" under the 1934 Act are required to conform to a comprehensive system of governmental and self-imposed regulation developed over the years for the protection of investors. Banks offering brokerage services outside a registered broker-dealer subsidiary, however, are not subject to the standards and safeguards provided under this system. As Table 1 illustrates,

these customer protections relate to advertising, broker training, suitability, prompt and best execution, prompt delivery of securities and confirmations with regard to each transaction, disclosure of adverse information, and insurance under the Securities Investor Protection Act.

TABLE 1

Regulatory Burdens to Which
Members of the Securities Industry
Are Subject

Brokerage Related and Investment Banking Services

1. Registration and licensing.

   A. Registration with SEC as broker-dealer under Section 15 of the Securities Exchange Act of 1934.
      1. Filing and updating of application.
      2. Periodic financial statement filings.
      3. Periodic fees.

   B. Membership in National Association of Securities Dealers, Inc. ("NASD").
      1. Requirements for maintaining books and records.
      2. Minimum capital requirements.
      3. Membership fees and charges.
      4. Compliance with "suitability" rules and other extensive Rules of Fair Practices.

   C. Membership on national securities exchanges.
      1. Requirements for maintaining books and records.
      2. Periodic financial reporting.
      3. Minimum capital requirements.
      4. Membership fees and charges.

   D. Licensing of securities salespersons with NASD and exchanges.
      1. Training.
      2. Examination.
      3. Bonding of employees.

2. Continuing regulatory obligations under Securities Exchange Act and rules of self-regulatory bodies.

   A. Minimum capital requirements (usually must be calculated daily).

   B. Rules regarding suitability of securities for an investor.

   C. Rules governing the appropriateness of advertising materials and requiring pre-clearance.

   D. Requirement of furnishing detailed confirmation of purchases and sales and periodic statements of accounts.

   E. Contribution to Securities Investor Protection Corporation.

   F. Rules requiring full disclosure of information on securities sold to customers.

   G. General rules regarding the duty owed by brokers to their customers under the so-called "shingle" theory, which seeks to hold brokers to high professional standards.

   H. Duty of broker-dealer principals to inquire into the good character and background of, and to supervise, their employees.

   I. Rules requiring the maintenance of detailed books and records.

   J. Rules requiring the prompt review of all transactions and correspondence of registered representatives.

Investment Advisory Services

1. Registration with SEC as investment adviser under Section 203 of Investment Advisers Act of 1940.

   1. Filing and updating of application.

   2. Filing fee.

   3. Books and records requirements.

2. Continuing regulatory obligations under Investment Advisers Act.

   A. Rules governing the appropriateness of advertisements.

B. Rules governing advisory contracts with customers.

C. Rules governing methods of calculating fees.

D. Rules requiring disclosure of capacity and prior consent when acting as principal with investor.

Despite recommendations of a special report to Congress on the bank "broker-dealer" exemption completed by the SEC in 1977,[39] the bank regulators have taken only the most tenuous steps to provide meaningful protection for bank securities customers.[40]

Banks do not value lightly their exemption from the 1934 Act. This became evident in late 1983 when the SEC, prompted by the spread of bank brokerage activity and "investor protection and other regulatory concerns raised by the recent expansion of bank securities activities," proposed a rule that would have required banks performing certain securities activities to register as broker-dealers under the 1934 Act.[41] The instantaneous and vigorous opposition of the major banking organizations, coupled with a belated attempt by the Comptroller of the Currency to reclaim the regulatory initiative from the SEC,[42] bear eloquent witness to just how important this exemption is to banks.

Shielded by their exemption, banks enjoy a substantial regulatory advantage over securities firms, which are subject to stringent controls. If Glass-Steagall's safeguards are to be abrogated, banks should be made subject to the same body of regulation that applies to others engaged in the securities

business. Moreover, regulation of bank securities activities would be best performed by a regulator with experience and knowledge in the field. The only such agency is the Securities and Exchange Commission.[43]

Bank Tie-Ins

Another unique competitive advantage of banks is their ability to extend credit, the availability of which can be "tied" to use of the bank's securities services. These tie-ins, whether explicit or implicit, involve the linkage of bank credit facilities with securities services.

A bank may condition lower borrowing costs or the availability of its credit facilities altogether on an issuer's patronage of the bank's private placement or commercial paper services. For example, most commercial paper is backed by a bank line of credit. This gives banks the opportunity to tie the availability of a credit line to use of the bank as distributor of commercial paper for the issuer.

Similar potential for a "tie-in" arises when a bank is asked to extend a letter of credit to support a certain type of tax-exempt housing revenue bond issue. These instruments, known as "option bonds" or "put bonds", normally are underwritten by a syndicate. They give holders the right to redeem their bonds at par on certain dates up to thirty years in the future, regardless of current market value. A letter of credit is provided, at a very substantial fee, to fund payments

to bond holders exercising their redemption option. The large money center banks have the unique ability to condition the granting of a letter of credit on being awarded managing underwriter status, and reportedly have done so frequently.

Whether or not such tie-ins are formal, potential borrowers may feel obligated to use various securities services offered by their bank in the belief that such patronage enhances their "creditworthiness." Underscoring how widespread such reasoning appears to be, one bank recently felt compelled to run television advertisements informing prospective loan customers that they were not required -- at least at that bank -- to have an account with the bank to secure a loan.[44]

Particularly when short term credit becomes a relatively scarce and valuable commodity, customers may feel obliged to be "good customers" of their bank in all respects.

The dangerous potential for voluntary tie-ins occuring in such circumstances was emphasized and illustrated by Richard W. McLaren, then Assistant Attorney General in charge of the Antitrust Division, in his testimony before the Senate Committee considering bank holding company legislation in 1970:

> Bank expansion in other areas permits the carryover of economic power into such endeavors. There is, of course, the obvious danger of overt reciprocity or tying arrangements, as well as general favoritism of bank affiliates, particularly in times of tight money. Also, and perhaps more important in terms of the need for present legislation, there are dangers which are of a more structural nature--adverse competitive effects that would tend to develop naturally without

> actual overt use of the economic power carried over from the banking sphere.
>
> I refer to a voluntary form of reciprocity or tie-in effect, where a potential borrower may independently decide that, just because he might possibly be under watch, it is in his best interest to patronize bank-affiliated enterprises in the hope of improving his chances of obtaining credit from the bank on favorable terms, or indeed at all.
>
> This can be illustrated by an example. A potential loan applicant might voluntarily place his casualty insurance business with a bank-affiliated insuror in hopes of improving his chances for a mortgage loan on the insured property on favorable terms. This would have the same effect as a coercive tie-in. Competition in the tied product, insurance, would be lessened to the extent that customers no longer purchased it entirely on its own economic merit. One such merger might well trigger others and as a pattern of such bank-insurance affiliations developed, market foreclosure in the tied field would become more and more serious.[45]

The Conference Committee that reported the Bank Holding Company Act Amendments of 1970 echoed McLaren's concerns:

> Such tie-ins may result from actual coercion by a seller or from a customer's realization that he stands a better chance of securing a scarce and important commodity (such as credit) by 'volunteering' to accept other products or services rather than seeking them in the competitive market place. In either case, competition is adversely affected, as customers no longer purchase a product or service on its own economic merit.[46]

Moreover, as is apparent from the following passage from a major bank holding company's anti-trust compliance manual for staff, it is altogether reasonable for a loan applicant to expect that bank lending officers will take into

account the applicant's other relationships with the bank and its affiliates:

> Also, the tying provisions [of the Bank Holding Company Act] do not prohibit the Bank, its operating subsidiaries, or the Corporation's domestic non-bank subsidiaries, from taking into account present or past satisfactory relationships with a customer when selling or pricing a loan or other service. However, this must remain an internal consideration and cannot be conveyed to the customer in terms which imply that the customer is expected to continue the other relationships in the future.[47]

The possibility of tie-ins occurring seems all the more likely when one considers the active "cross marketing" of products in which banks engage. The heightened danger should be clear from another excerpt from the anti-trust compliance manual. After cautioning bank officers against illegal mandatory tie-ins, the manual states:

> Bank officers can offer to customers the full range of available Bank services which may be of interest to the customers. They can also advise customers of the availability of services offered by affiliates of the Bank and can offer to put the customer in touch with the affiliate if the customer so desires.[48]

While cross-marketing is not illegal, it seems apparent from the emphasis given to the practice by major

banking organizations that most customers do not fail to take the hint.

Conclusions

Bankers are fond of calling for repeal of the Glass-Steagall Act to create a "level playing field," permitting head-to-head competition between banks and securities firms. But as long as banks enjoy the advantages of Government-granted preferential access to credit, exemption from securities regulations, and ability to tie bank services with non-bank services, talk of a level playing field is disingenuous at best.

The Congressionally-designed system of distinct financial intermediaries -- with different tax and regulatory schemes -- was no accident. It was the product of reasoned thought and careful Congressional debate.

Bank Securities Activities: A Historical Perspective

Since enacting the National Bank Act in 1864,[49] Congress repeatedly has reaffirmed its determination that the public policy of the United States must be to separate commercial banking from unrelated areas of economic or commercial activity. Indeed, the history of federal bank regulation -- as reflected in enactment of the Glass-Steagall Act, the Bank Holding Company Act of 1956 and the Bank Holding Company Act Amendments of 1970 -- largely has been an effort to restrain the domination of commercial banks over non-banking sectors of the economy.

Recent revisionist arguments by a few money-center banks contend the Glass-Steagall Act was the handiwork of a single misguided Senator.[50] In fact, the Act was the product of widespread Congressional indignation; justifiable ire over the role of national banks in fostering the rampant speculation that culminated in the financial crises of the late 1920s and early 1930s. Congress felt that the Federal Reserve System had been used to facilitate speculative securities operations and to finance excessive securities lending, in total disregard of the system's purpose. As stated in the Senate Report on the bill ultimately passed into law,

> [t]he outstanding development in the commercial banking system during the prepanic period was the appearance of excessive security loans, and of over-investment in

> securities of all kinds. The effect of this situation in changing the whole character of the banking problem can hardly be overemphasized. National banks were never intended to undertake investment banking business on a large scale, and the whole tenor of legislation and administrative rulings concerning them has been away from recognition of such a growth in the direction of investment banking as legitimate. Nevertheless it has continued; and a very fruitful cause of bank failures, especially within the past three years, has been the fact that the funds of various institutions have been so extensively 'tied up' in long-term investments.[51]

Senator Glass, the principal Senate sponsor of the Act, speaking on the Senate floor, stated that:

> [N]ot only has the Federal reserve banking system been used in an inordinate measure in stock market transactions, but there appears to have been an extraordinary misconception by the administrators of the act of its real purpose. In large degree, the system has been transformed into an investment banking system, whereas the fixed purpose of Congress was to set up a commercial banking system and to preclude speculative operations....
>
> Let me tell [the] Senators the meaning, and, in the last analysis, the result of that sort of administration of the law. It means that a member bank may engage in any sort of speculative business it may please, and then, when its reserve in the Federal reserve bank is impaired, it may take its eligible paper for rediscount and use the credit and the currency thus afforded to reestablish its reserve, and not to relend for 'commercial, industry, or agricultural purposes.'
>
> That is an evasion of the intent, the spirit, and text of the Federal reserve banking act. It never was intended that its facilities should be used for investment purposes, or for speculative purposes, in that roundabout way.[52]

Indeed, the "gambling fever" of the prepanic years was attributed to the rapid growth of the banks' securities business. In the words of Senator Walcott, a member of the Senate Banking and Currency Committee who addressed the Senate on the provisions of the Act relating to bank affiliates,

> It reached such a volume, there were so many willing purchasers, so much credit for investment purposes was available that there resulted a complete change in our banking system....The commercial banking business in consequence of this extraordinary volume of security business declined... The net result of it all was that we were in the flood tide of speculation....How was all this expansion possible?....It took money, currency; it took a very expansive credit, which, of course, brought in the banks. As far back as 1911 the banks were investing heavily in securities, buying and selling securities. Most of the banks had been engaged in underwriting, and still are. The security business became such an important part of the operations of some of the banks, particularly of two or three of our larger banks, that some fear was occasioned that they would get away from the strictly commercial business for which they were organized and put out securities of doubtful value.... [T]here was a conflict between the business of marketing securities and the business of protecting depositors' money....[T]he national banks engaged in the security business were compelled to divorce their security business from their banking operations, and the term 'affiliates' came into being as the result of that divorce.[53]

The practice of the Bank of the United States in creating securities affiliates -- which had become prevalent with the recognition by banks of the profits they could derive from the distribution of securities -- was cited as a "typical case of the excessive abuse of affiliates." Many undercapitalized

affiliates had been created, financed by shoe-string operations. As suggested by Senator Walcott, "of course it was inevitable that this great structure of innumerable affiliates should collapse."[54]

Senator Bulkley, another member of the Senate Committee on Banking and Currency who addressed Congress on the legislation, posed the following question:

> When the national banks, through their affiliates, followed into the investment banking business...the idea of increased profits more and more obsessed our bankers... Did not professional pride become diverted from the pride of safe and honest banking service to that of profits, greed, expansion, power and domination?[55]

Much of the problem, it was believed, stemmed from the fact that permissive state bank regulation put pressure on the federal regulators to allow national banks to step beyond the boundaries of sound banking. As expressed by Senator Walcott, the net result was

> the disregard of a great many of the fundamentals of the banking business, taking chances with depositors' money, and the incorporation and rapid growth of the affiliate business, giving an outlet to that speculative type of business quite contrary to legitimate commercial banking.[56]

The banks, having established sales departments to engage in the distribution of securities, needed to cultivate markets in which to sell securities. They also required securities to sell. To facilitate stock purchases, banks made

loans, a practice which fed securities speculation and was condemned by Senator Walcott:

> It is evident from what has been said that the underlying factor in the whole prepanic situation was excessive use of bank credit... The excessive use of bank credit in making loans for the purpose of stock speculation, or, more generally stated, for the excessive carrying of securities with borrowed money, was generally admitted before the panic of 1929, and almost universally since that time, to have been one of the sources of major difficulty, far exceeding in its scope any total that could be reasonably asked for as a basis for the financing of legitimate investment business.[57]

It became necessary to seek out issuers, even though issuing corporations, in many cases, had little or no need for long-term capital. As Senator Buklley put it,

> Can any banker, imbued with the consciousness that his bond-sales department is, because of lack of securities for sale, losing money and at the same time losing its morale, be a fair and impartial judge as to the necessity and soundness for a new security issue which he knows he can readily distribute through channels which are expensive to develop but which presently stand ready to absorb the proposed security issue and yield a handsome profit on the transaction.[58]

It was easy, Senator Bulkley stated, to see why the banks' securities businesses were overdeveloped and why they overloaded the country with unfortunate investments.[59] On the other hand, he said, if

> the business of originating and underwriting investment securities is confined to houses not engaged in deposit banking, then the

> extent and the desirability of new issues will be subjected to an independent and impartial check.[60]

As a corollary consideration, the business of investment banking by commercial banks necessarily involved taking risks. If a bank's securities affiliate suffered a loss, rumors might spread that the bank's financial condition would be impaired due to its loans to its affiliates. Rumors of stock price manipulation and other abuses of the distribution system, and the possibility of litigation against the banks, also posed a threat to depositor confidence. Senator Bulkley considered the special role of the commercial banker:

> The banker ought to be regarded as the financial confidant and mentor of his depositors...Obviously, the banker who has nothing to sell to his depositors is much better qualified to advise disinterestedly and to regard diligently the safety of depositors than the banker who uses the list of depositors in his savings department to distribute circulars concerning the advantages of this, that, or the other investment on which the bank is to receive an originating profit or an underwriting profit or a distribution profit or a trading profit or any combination of such profits.[61]

His conclusion was unequivocal:

> If we want banking service to be strictly banking service, without the expectation of additional profits in selling something to customers, we must keep the banks out of the investment security business.[62]

Congress came to the same conclusion. Based on several years' study, and finding that the marriage of commercial banking and securities activities had undermined and ultimately precipitated the collapse of our banking system, Congress declared that commercial banking be divorced from investment banking. It was a remedy precisely suited to the defined ills of the banking system.

Indeed, as viewed almost 40 years later by the United States Supreme Court in the 1971 landmark case, Investment Company Institute v. Camp, the Glass-Steagall Act reflected a "determination that the policies of competition, convenience, or expertise which might otherwise support the entry of commercial banks into the investment banking business were outweighed by the 'hazards' and 'financial dangers' that arise when commercial banks engage in such activities proscribed by the Act as general securities trading."[63] As the Court reaffirmed a decade later, Congress meant to "separat[e] as completely as possible commercial from investment banking ..."[64]

Current Developments

Only recently, the Supreme Court emphatically reiterated the considerations that led to enactment of the Glass-Steagall Act. In Securities Industry Association v. Board of Governors of the Federal Reserve System,[65] the court emphasized that the Act had been passed primarily in

response to two concerns: the inherent risks of the securities business and the "crisis of confidence" that precipitated the devastating collapse of the banking system. Quoting from Camp, the Court further noted Congress' concern with

> "the more subtle hazards that arise when a commercial bank goes beyond the business of acting as fiduciary or managing agent and enters the investment banking business." Camp, 401 U.S., at 630. The Glass-Steagall Act reflects the 1933 Congress' conclusion that certain investment banking activities conflicted in fundamental ways with the institutional role of commercial banks....The Act...reflects the Congressional perception that certain investment banking activities are fundamentally incompatible with commercial banking.[66]

Moreover, the Supreme Court recognized that while the separation of investment from commercial banking resulted in some loss of efficiency and competition, the Glass-Steagall Act reflected the Congressional view that the "subtle risks created by mixing the two activities justified a strong prophylaxis."[67]

Although the Glass-Steagall Act is the principal legislative constraint to bank involvement in the securities industry, the larger theme which it sounded -- the necessity of insulating banking from other areas of commerce -- has dominated subsequent bank reform legislation. The Bank Holding Company Act of 1956[68] was intended, among other things, to separate banking from other areas of commerce. Such separation was felt necessary to prevent banks from employing funds entrusted by depositors in nonbanking enterprises and to guard

against banks using their myriad advantages in competing with such enterprises. As stated in the Report of the Senate Committee on Banking and Currency, "bank holding companies ought not to manage or control nonbanking assets having no close relationship with banking."[69]

Concern over the safety of depositors' funds was expressed in several ways. The then Chairman of the Board of Governors of the Federal Reserve System, William McChesney Martin, Jr., expressed concern over the use of depositors' funds in nonbanking businesses:

> ...the ordinary nonbanking business requires a managerial attitude and involves business risks of a kind entirely different from those involved in the banking business. Banks operate largely on their depositors' funds. These funds should be used by banks to finance business enterprises within the limitations imposed by the banking laws and should not be used directly or indirectly for the purpose of engaging in other businesses which are not subject to the safeguards imposed by the banking laws.[70]

Chairman Martin also stated that the combination of banking and nonbanking enterprises

> involves the lending of depositors' money, whereas other types of business enterprise, not connected with banking, do not involve this element of trusteeship.[71]

The report of the House Banking and Currency Committee put it somewhat differently:

> banks are prohibited from engaging in any other type of enterprise than banking itself...because of the danger to the

> depositors which might result where the bank finds itself in effect both the borrower and the lender.[72]

Aside from concern that biased and imprudent extensions of credit to nonbanking affiliates of a bank may seriously jeopardize the funds of its depositors, the report of the Senate Committee also warned that such

> a bank holding company might misuse or abuse the resources of a bank it controls in order to gain an advantage in the operation of the nonbanking activities it control[s].[73]

The report of the House Committee provides further illustration of this concern:

> If banks were permitted to own nonbanking businesses they would be compelled in many instances to extend credit to such businesses to the detriment of other competitive businesses in the community and possibly also to a degree which would be unsound from a banking viewpoint. A bank should always be at arms' length with its borrowers and such a position could not be maintained were banks permitted to own nonbanking businesses and make credit available to them.
>
> Whenever a holding company thus controls both banks and nonbanking businesses, it is apparent that the holding company's nonbanking businesses may thereby occupy a preferred position over that of their competitors in obtaining bank credit. It is also apparent that in critical times the holding company which operates nonbanking businesses may be subjected to strong temptation to cause the banks which it controls to make loans to its nonbanking affiliates even though such loans may not at that time be entirely justified in the light of current banking standards. In either situation the public interest becomes directly involved.[74]

These same concerns -- about the safety of depositors' funds and unfair competition -- as well as fears of undue concentration of power in bank holding companies, led to enactment of the Bank Holding Company Act Amendments of 1970.[75] The primary purpose of the 1970 Amendments was to close the 1956 Act's one-bank holding company loophole in order to preserve the basic separation of bank and bank-related activities from other business activities.[76]

Concerns Over Bank Advantages

The debates on the 1970 Amendments raised, among other concerns, the specter of unfair competition. Representative Wright Patman, Chairman of the House Banking Committee, stated as one of the factors requiring closing of the one-bank holding company loophole the threat of "[l]oan discrimination of banks in favor of enterprises owned by the holding company and against companies which compete with subsidiaries of the holding company."[77]

In his testimony at the Senate hearings, Federal Deposit Insurance Corporation Chairman Frank Wille cited both unfair competition and concentration of economic resources as reasons for the one-bank holding company legislation:

> The Federal Deposit Insurance Corporation believes that the activities of one-bank holding companies should be brought promptly under effective regulatory control at the Federal level in order to prevent an unhealthy concentration of the nation's economic resources and to control possible anti-

> competitive practices in the allocation of credit and financial services within the nation's economy.[78]

As indicated in the following colloquy occurring during Senate floor actions on the Amendments, the Congress was careful to avoid any narrowing of the restrictions of the Glass-Steagall Act:

> MR. WILLIAMS of NEW JERSEY:....I wonder whether there was any intention to imply that the very securities-related activities forbidden to banks directly may nevertheless be engaged in by bank-holding companies or their non-banking affiliates.
>
> MR. SPARKMAN: The answer to the Senator's question is that there clearly was not.[79]

Thus, one of the primary goals of banking legislation since 1933 has been the separation of banking from other areas of commerce. The Glass-Steagall Act was enacted in reaction to the abuses of banks and their securities affiliates which exacerbated the speculative fervor of the 1920s and led to the 1929 stock market crash.

Despite Congressional indignation, the banks' desire to remove Glass-Steagall protections began almost immediately after the Act was signed. In 1935, they argued that the two years following passage of the Act had not produced an independent underwriting industry. Senator Robert LaFollette countered that there was no evidence of a "lack of capital or financing facilities." The problem of heavy industry, he noted in the depths of the Depression, was that "they have not got

enough orders." Referring to the banks' attempts to return to the securities business, Senator LaFollette said:

> As I see it, it is the nose of the camel under the tent. Write into the law this provision recommended by the Committee, and at the next session of Congress there will be proposals further to relax it...If we take this step, next year we shall have half the camel under the tent, and the next year after that we shall have the camel in the tent, and the next year after that we shall be right back where we were in 1929."[80]

By the mid-1950s, the phenomenon of bank holding companies engaged in businesses other than banking was in part responsible for the enactment of the Bank Holding Company Act of 1956. Behind its provisions separating commerce and banking were concerns that a combination of the two would unduly jeopardize the funds of depositors and lead to unfair competition with nonbanking enterprises. These concerns were reaffirmed in 1970 when the Congress enacted the one-bank holding company legislation.

Conclusions

In sum, Congress willingly has accorded banks a number of special privileges[81] that support and reinforce their position as principal suppliers of credit to the private sector. Yet recognition of banks' pivotal role in the economy, concerns about concentrations of power, safety of depositors' funds, and the potential for conflicts of interest and unfair competition have led Congress to be cautious of bank expansion

into areas of general commerce. On the three occasions in the past half-century when Congress addressed the issue -- in 1933, 1956 and 1970 -- it concluded in each instance that the range of non-banking activities permissible for commercial banks and their affiliates must be carefully circumscribed in the interest of sound public policy.

While promoting the safety and soundness of our nation's banks, Congressional policy has produced a financial system that is competitive for all intermediaries.

Competition: The Banking Canards

Banks have employed several arguments to support their desire to enter the securities business: that the risks of securities activities would not impair, and actually improve, their safety; that dangers of self-dealing and conflicts of interest can be checked by regulation; and -- their new revisionist tack -- that the Glass-Steagall barrier to bank securities activities was misguided. Perhaps the banks' most compelling argument, especially in a political climate receptive to free market rhetoric, is that bank entry would increase competition in an industry that, they claim, sorely lacks competitive vigor.

Taken as the tautology that it is, the assertion that bank entry in the securities industry would immediately increase competition cannot be denied. Obviously, the moment a law became effective that permitted banks to engage in previously prohibited activities, several of the more aggressive banks would begin competing with securities firms. Yet a closer examination of the competitive aspects of bank entry reveals that the Government-protected and subsidized banking industry would eventually subsume the free market securities industry, resulting in less long-run competition.

Banks have turned the competition argument on its head. While only recently learning to compete among themselves

-- and still largely immune from geographic and price competition -- banks fail to disclose their unique, Government-supported advantages when seeking additional powers. At the same time, they charge that the securities industry is a protected entity with restrictions that somehow insure high profits.[82] The securities industry, in truth, is highly competitive. It is characterized by low barriers of entry and an extremely volatile pattern of profitabilty, and a degree of concentration similar to that of the banking industry.

Barriers to Entry

The securities industry is among the easiest of businesses to enter. In each of the past five years, for example, an average of 52 securities firms became newly admitted members of the New York Stock Exchange. A typical year also saw the departure of 34 firms.

Other than banks, no category of enterprise is prohibited from engaging in the securities business. As recent acquisitions in the industry confirm, securities firms are owned by retailers, insurers, and diversified financial organizations. Companies that manufacture office copiers and those that produce television programs[83] also own broker-dealers. Any commercial entity that believes it can use its capital profitably by entering the securities business may choose to do so. Minimum capital for a general broker-dealer is only $25,000.

Oddly, banks claim that "barriers to entry into the upper echelons of underwriters are high because of the value corporations place on an investment bank's reputation, track record, personnel quality, areas of specialization and size."[84] This is tantamount to declaring that the competency of existing participants is a barrier to entry! Nevertheless, obtaining the status of a major securities firm is possible, and indeed has been attained, by those willing to make the capital and human resources commitments themselves, or by those wishing to purchase an existing firm.

Under the Glass-Steagall Act, only banks are precluded from entering the securities business; the Act is no bar to any other type of enterprise. If the profits of the securities industry were are as "unusually high"[85] as the banks' suggest, why then has America's overwhelmingly dominant non-banking sector not flocked to the securities industry?

Securities Industry Profitability

Risk and earnings volatility are the probable reasons Corporate America approaches investing in the securities industry with caution. The securities business is inherently risky and subject to violent swings in profitability. Plotting the securities industry's annual after-tax return on equity against comparable figures for the banking industry, is much like comparing ocean swells to ripples on a pond (Table 2).

Table 2

Comparison of After-Tax Return on Equity (ROE) in Securities and Banking Industries, 1973-1984

	Securities Industry After-Tax ROE	Commercial Banking After-Tax ROE
1973	(3.0)%	Not Available
1974	0.7	12.59%
1975	16.6	11.75
1976	17.6	11.48
1977	6.9	11.71
1978	11.2	12.90
1979	15.6	13.90
1980	26.6	13.68
1981	19.4	13.12
1982	21.9	12.08
1983	19.8	11.12
1984	7.2	10.68
Standard Deviation	7.3	1.0

Sources: Securities Industry Association and American Bankers Association

While full-year figures illustrate the securities industry's considerable volatility, the quarterly figures reveal even greater swings (Table 3).

Table 3

Quarterly After-Tax Return on Equity in the Securities Industry, 1979-1984

	1Q	2Q	3Q	4Q
1979	14.5%	17.0%	19.2%	13.1%
1980	14.3	39.1	22.7	29.4
1981	26.0	23.2	8.0	21.1
1982	5.5	9.1	28.5	41.3
1983	29.9	31.2	14.8	6.0
1984	9.2	(1.8)	12.5	8.7

Source: Securities Industry Association

Comparing the securities industry's erratic quarterly results to the relatively static returns of the banking industry, (Table 4), leads one to question how entering the securities industry will help banks even their "volatile" earnings stream.[86]

Table 4

Quarterly and Half-Yearly After-Tax Return on Equity of FDIC Member Banks, 1976-1984

		After-Tax Return on Equity
1976		
	First Half	11.2%
	Second Half	11.5
1977		
	First Half	11.1
	Second Half	12.3
1978		
	First Half	12.8
	Second Half	13.0
1979		
	First Half	15.6
	Second Half	12.2
1980		
	First Half	14.2
	Second Half	13.1

1981		
	First Half	13.9
	Second Half	12.2
1982		
	First Half	12.6
	Second Half	11.6
1983		
	First Quarter	13.0
	Second Quarter	12.1
	Third Quarter	10.7
	Fourth Quarter	8.9
1984		
	First Quarter	12.0
	Second Quarter	9.1
	Third Quarter	12.1
	Fourth Quarter	9.6

Source: Federal Deposit Insurance Corporation

Securities firms, in fact, are all too aware of their earnings volatility, have "been making strenuous attempts to diversify away from the securities industry into other lines of activity. They have taken these steps to improve profitability and to reduce the volatility of their earnings."[87] In fact, revenues from activities unrelated to the securities business have risen from $105 million in 1975 to $1.8 billion in 1984.

The banks' use of the five years 1979-1983 as a basis of comparison for the profitability of the securities industry vis-vis banking is misleading. Those were years of record profitability for the securities industry. In 1973, for example, the industry sustained a loss resulting in the departure of 13% of New York Stock Exchange member firms. The mid-seventies was a time of marginal profitability, and performance was not good in 1984.[88]

Equally misleading is the tendency of commercial banks to attribute the profitability of large investment banks to the category known as "securities underwriting and trading." In a recent paper, for example, J.P. Morgan and Company labels as "profits" the gross revenues of securities firms in the areas of underwriting and trading.[89] The substantial expenses of these activities -- interest expense, the cost of maintaining a corporate finance department, a research department, and the general overhead of the firm, for example -- simply are ignored.

Furthermore, the underwriting and selling of corporate securities is not as profitable as the commercial banks believe. The reporting category "underwriting and trading" consists of revenue from both corporate and government underwriting, with much of the revenue derived from the trading of government debt. Corporate debt is a relatively small fraction of the total debt position of securities firms. Commercial banks revenue from both corporate and government underwriting, with much of the revenue derived from the trading of government debt. Corporate debt is a relatively small fraction of the total debt position of securities firms. Commercial banks already compete in federal government and agency debt and selected revenue bond areas.

Similarly, banks make a case that the "limited number of competitors in corporate underwriting and dealing markets has resulted in high profits for the securities firms that supply these services."[90] In truth, the underwriting and selling of corporate securities are relatively unimportant in the revenue scheme.[91] In firms characterized as large investment banks by the New York Stock Exchange, most profits are earned in areas which are open to commercial bank

competition -- U.S. Government securities trading, mergers and acquisition advisory services and other fee-based business.

Concentration Arguments

Despite a superficial plausibility, there is no empirical evidence that banks' inability to underwrite leads to concentration in underwriting markets, to high underwriting profits, to higher costs for issuers, or to limited availability of underwriting and marketmaking services for small businesses. Since 1974, in fact, the number of over-the-counter market-makers and the average number of market-makers per security have increased (Table 5).

Table 5

NASDAQ Securities and Market Makers
1975-1984

Year	No. of Securities	Active Market Makers	Market Making Positions	Average Market Makers Per Securitiy
1984	4,723	459	38,739	8.2
1983	4,467	441	32,923	7.4
1982	3,664	407	27,734	7.6
1981	3,687	420	26,935	7.4
1980	3,050	394	22,360	7.3
1979	2,670	364	21,768	8.2
1978	2,582	355	19,898	7.7
1977	2,575	353	19,479	7.6
1976	2,627	365	19,960	6.5
1975	2,579	369	14,340	5.6

Source: National Association of Securities Dealers

Reflecting the competitiveness of the business, the composition of the top ten corporate underwriting firms also has

undergone a significant shift in recent years. Drexel Burnham Lambert, for example, has moved from twelfth to fourth place in six years, while acquisitions have propelled Shearson Lehman Brothers to seventh place from twentieth. As these firms have improved their relative positions, other firms have moved down in the rankings.

Conclusions

Since the securities industry already is open to all manner of competition, there is no evidence that the entry of commercial banks -- the only enterprises prohibited from certain kinds of underwriting activities -- would increase long-run competition in the securities industry. Given the tax and other advantages enjoyed exclusively by banks, it would not be unreasonable to assume that these economic subsidies would be used to compete with other, nonsubsidized businesses.

Footnotes

1. J. P. Morgan & Company, Inc., Rethinking Glass-Steagall, December, 1984; Thomas F. Huertas, Vice President, Citibank, An Economic Brief Against Glass-Steagall, Autumn, 1984.

2. U.S. News & World Report, July 9, 1984

3. Newsweek, July 9, 1984

4. Id.

5. The New York Times, May 20, 1984.

6. Id.

7. FDIC 1983 Annual Report at 53; FDIC 1984 List of Bank Failures (undated mimeo).

8. "Bank Failures Expected to Rise," The Washington Post, May 9, 1985, at B1.

9. Washington Post, Feb. 28, 1985.

10. Id.

11. NY, April 26, 1985, at D1.

12. Id.

13. This was a specific focus of the Supreme Court in its review of Congressional concern in this field. ICI v. Camp, supra n. 6, at 630-31.

14. The full range of conflicts in which banks became entangled during the REIT debacle is well-chronicled in Investment Company Institute, Misadventures in Banking: Bank Promotion of Pooled Investment Funds, pp. 10-19 (1979).

15. The REIT industry has experienced a recent resurgence. [Further details and cite.]

16. After a lengthy review of the legislative history of the Glass-Steagall Act and the possibility of serious problems that could result from the involvement of banks in the securities field, the Supreme Court in ICI v. Camp stated:

> In sum, Congress acted to keep commercial banks out of the investment banking business

> largely because it believed that the promotional inventives of investment banking and the investment bankers' pecuniary stake in the success of particular investment opportunities was destructive of prudent and disinterested commercial banking and of public confidence in the commercial banking system. 401 U.S at 634.

17. Business Week, February 11, 1985.

18. SIA v. Fed., supra n. 9, at 4946.

19. The global repercussions which such events can trigger is reflected in the following excerpt from a Washington Post story of March 20, 1985:

> The American dollar suffered its biggest single-day loss in at least 14 years yesterday -- the second day in a row it was clobbered in foreign exchange markets -- as traders exhibited nervousness about the American banking and financial system in the wake of the troubles of 70 thrift institutions in Ohio.
>
> Fear that the closed savings and loan associations there might be symptomatic of more serious problems in the United States, sent gold -- always a refuge in a monetary storm -- soaring $37.50 an ounce on the New York Commodity Exchange to $339 for the biggest daily gain in a decade.
>
> Trading was heavy and hectic, and the dollar price against most major currencies plunged heavily at the end.
>
> According to the Federal Reserve Board, the dollar dropped 2.39 percent against the currencies of 10 other industrial countries yesterday, putting it down 5.54 percent from the all-time high reached on Feb. 25. That was the largest daily decline in Fed records that go back to Jan. 1, 1971. . . .

20. Time, April 1, 1985.

21. NY Times, May 16, 1985.

22. Washington Post editorial, March 19, 1985.

23. 44 Washington Federal Reporter 522 (1985).

24. The Economist, March 9, 1985.

25. Wall Street Journal, March 25, 1985.

26. Business Week, January 28, 1985.

27. New York Times, April 3, 1985.

28. Id.

29. Id.

30. Washington Post, May 9, 1985.

31. "Are Banks Special?," the 1982 Annual Report of the Federal Reserve Bank of Minneapolis.

32. Until 1982, banks, thrifts, and certain other financial institutions could invest their depository funds in tax-exempt obligations while taking a full deduction for interest paid on their deposits or short-term obligations. Such financial institutions are denied only 20 percent of their interest deduction allocable to indebtedness (including deposits and other short-term obligations), incurred or continued in order to purchase or to carry tax-exempt obligations acquired after 1982.

    Banks are permitted to reserve against future loan losses and to deduct such reserve from gross income. Sections 585 and 593 of the Internal Revenue Code. Only 20% of this deduction is denied as a financial institution preference item under Section 291 of the Code.

33. Joint Committee on Taxation, Taxation of Bank and Thrift Industries, March 9, 1983, Table 2.

34. 12 U.S.C. § 371c (1984).

35. P.L. No. 97-320, § 410. The Banking Affiliates Act of 1982 constituted part of Title IV of the Garn-St. Germain Depository Institutions Act of 1982.

36. Rose and Talley, "Bank Transactions with Affiliates: The New Section 23A," 100 Banking L. J. 423, 435 (1983).

37. Form 10-K, Chemical New York Corporation, 45 (1984).

38. Form 10-K, BankAmerica Corporation, 38 (1984).

39. Securities and Exchange Commission, Final Report on Bank Securities Activities, June 30, 1977, reprinted in Senate Committee on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess., Reports on Banks Securities Activities of the Securities and Exchange Commission at 289 (Comm. Print 1977).

40. The bank regulatory agencies have not even attempted to address certain key recommendations of the SEC. For example, bank securities personnel still are not subject to any testing or licensing requirements or to any regulations governing their substantive knowledge of the securities business or its legal requirements. Moreover, the limited steps that have been taken by bank regulatory agencies do not come close to approximating the system of broker-dealer regulation designed for the protection of investors. In 1979, in response to the SEC's recommend- ations, the banking agencies adopted regulations governing recordkeeping and confirmation requirements and requiring banks to establish written policies and procedures providing for, among other things, the assignment of responsibility for supervision of securities personnel. 12 C.F.R. § 12 (Comptroller); 12 C.F.R. § 208 (Federal Reserve Board); 12 C.F.R. § 344 (FDIC). There are a number of discrepancies between these rules and the rules of the SEC, however. For example, the SEC's confirmation rule requires that broker-dealers generally must send customers a written confirmation of a securities transaction within five days of the transaction. Exchange Act Rule 10b-10, 17 C.F.R. § 240.10b-10 (1984). The rules of the bank agencies provide several exceptions to this requirement that are not present in the SEC's rules, such as permission for quarterly confirmations where the bank exercises investment discretion over an account in an agency capacity. In addition, unlike the regulations applicable to broker-dealers, no particular procedures are specified to ensure adequate supervision of employees effecting securities transactions for customers. In sum, the rules of the banking authorities tend to be considerably more general than those of the SEC, in many cases relying on reference to "sound banking practices" rather than the more specific regulations applicable to securities firms.

41. Proposed Rule 3b-9, 48 Fed. Reg. 51930 et seq., November 15, 1983.

42. See Comptroller's proposed rule governing banks' brokerage services, 49 Fed. Reg. 15089 (April 17, 1984).

43. In its recommendations regarding the restructuring of regulation of the financial services industry, the so-called "Bush Task Group" in 1984 concluded that the SEC should be the exclusive regulator of securities activities of banks and thrifts. Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services, 91, U.S. Gov't Printing Office (July 1984).

44. Set forth below is the transcript of a television commercial used by First Virginia Bank in the spring of 1985:

> "I'd like to apply for a loan." (door slams)
>
> "Excuse me, I'd like to apply for a loan."
>
> "Do I know you?" (bank representative makes gesture declining to accept loan application)
>
> "Some banks would rather not make loans to our customers too, but you don't have to bank here to borrow here."
>
> "At First Virginia Bank, we make loans to our customers too, but you don't have to bank here to borrow here."
>
> "First Virginia is committed to providing below market rates. You name it, and First Virginia has a low cost loan to suit your needs."
>
> "And remember, you don't have to bank here to borrow here. First Virginia Bank."

45. One Bank Holding Company Legislation of 1970, Hearings Before the Senate Comm. on Banking and Currency, 91st Cong. 2d Sess. 239-40 (1970). See also Mr. McLaren's remarks before the House Committee: The Bank Holding Company Act Amendments: Hearings Before the House Comm. on Banking and Currency, 91st Cong., 1st Sess. 91-92 (1969).

46. H.R. Rep. No. 1747, 91st Cong., 2nd Sess. 18 (1970).

47. BankAmerica Corporation, Antitrust Compliance, p. 6 (1980) (emphasis in original).

48. Id. at 6-7.

49. 12 U.S.C. § 165 (1976). The Act limited the power of banks chartered by the federal government to engage in activities other than traditional banking functions.

50. See Citibank, "An Economic Brief Against Glass-Steagall" (1984).

51. S. Rep. 77, 73rd Cong., 1st Sess. 8 (1933).

52. 75 Cong. Rec. 9884 (May 10, 1932).

53. Id. at 9904.

54. Id. at 9905.

55. Id. at 9911.

56. Id. at 9906.

57. Id.

58. Id. at 9911.

59. Id.

60. Id. at 9912.

61. Id.

62. Id.

63. Investment Co. Institute v. Camp, 401 U.S. 617, 630 (1971)(hereinafter cited as ICI v. Camp).

64. Board of Governors, F.R.S. v. Investment Co. Institute, 450 U.S. 46, 70 (1981).

65. 52 U.S.L.W. 4943 (June 28, 1984) [hereinafter cited as SIA v. Fed].

66. Id. at 4946.

67. Id. (citation omitted).

68. 12 U.S.C. § 1841 et seq. (1976 & Supp. III 1979).

69. S. Rep. No. 1095, 84th Cong. 1st Sess. 1 (1955).

70. Hearings on S. 2577 Before a Subcomm. of the Senate Comm. on Banking and Currency, 84th Cong., 1st Sess., at 75 (1955).

71. S. Rep. No. 1095, 3.

72. H.R. Rep. No. 609 on H.R. 6227, 84th Cong. 1st Sess., as reproduced in 101 Cong. Rec. 8038, 8042 (June 13, 1955).

73. S. Rep. No. 1095, 14.

74. H.R. Rep. No. 609 in 101 Cong. Rec. at 8039, 8042.

75. Bank Holding Company Act Amendments of 1970, 84 Stat. 1960 (codified in scattered sections of 12, 31 U.S.C.).

76. H.R. Rep. No. 1747, 91st Cong., 2d Sess. 11-12 (1970); see, 115 Cong. Rec. 32890, (1969) (remarks of Mr. Smith, member of the House Rules Committee, in support of a resolution regarding House debate on one bank holding company legislation).

77. 115 Cong. Rec. 32893 (remarks of Rep. Patman). See also, id. at 38291 (remarks of Rep. Bennett), id. at 32903 (remarks of Rep. Moorhead).

78. One Bank Holding Company Legislation of 1970, Hearings Before the Committee on Banking and Currency, United States Senate, 91st Cong. 2d Sess., 1970, p. 172.

79. 116 Cong. Rec. 42430 (1970).

80. Cong. Record 19331.

81. See discussion infra at pp. 12-24.

82. See J.P. Morgan & Co., Incorporated, "Rethinking Glass-Steagall" (1984), p. 30.

83. The parent of Van Kampen Merritt Inc. is the Xerox Corporation. Herzfeld & Stern Inc. is part of Josephson International, Inc., a diversified entertainment company.

84. op. cit.

85. Id.

86. Id.

87. Securities Industry Trends, June 29, 1979

88. Id.

89. See Morgan, p. 15.

90. Id.

91. In 1983 and 1984, respectively, underwriting and selling corporate securities contributed 12.8 percent and 7.3 percent to the revenues of large investment banking firms.

APPENDIX A

SIA's Ten Point Program For Analysis of Equitable Bank-Securities Competition

1. Only a separately capitalized, arm's length subsidiary of a bank holding company ("securities affiliate") should be permitted to underwrite and trade with any new securities powers. The capitalization of the securities affiliate should not unfairly benefit from affiliation with the bank holding company complex (e.g., access to lower cost capital and federally insured deposits).

2. Because banks are special, The securities affiliate should be the only member of the bank holding company family to engage in securities activities. It should take over all securities activities presently carried on by members of the bank holding company complex, including trust and pension securities management and investment advice. All securities activities should be defined to include all those which if carried on by a securities firm would be subject to regulation by the Securities and Exchange Commission as well as all activities involving exempt securities. If the securities affiliate is to be an equal competitor, its regulatory status should be the same as that of a broker-dealer. All of the securities laws should apply, with supervision in the Securities and Exchange Commission.

3. No member of the bank holding company complex should be allowed to use its assets or business relationships to assist the securities affiliate in its securities activities. Creation of the affiliate alone will not provide the required isolation. Many of the pre-Glass-Steagall abuses involved bank security affiliates. All financial transactions, purchases and sales of products and services, as well as credit transactions, between the securities affiliate and the bank holding company complex should be prohibited. Favoritism in the availability of funds would be impossible to police. The securities affiliates should go elsewhere for its credit and customers. (The problem of reciprocal dealing between the securities affiliate of one bank holding company complex in return for similar dealings from others must also be addressed.) Only in this way can the securities affiliate be separated from the privileges and advantages of bank members of the complex. Also, a securities affiliate should be barred from dealing with customers of other members of the bank holding company complex in ways that could involve the shifting of risks to and from the securities affiliate.

4. Bank deposits should be completely insulated from the risks assumed by a securities affiliate and should not directly or indirectly become of benefit to a securities affiliate. Federal insurance of deposits is a significant advantage for commercial banks that contributes to public

confidence in and the stability of the banking system. This advantage should not be made available for purposes unrelated to these goals.

5. The tax treatment of securities affiliates and of banks that are allowed to continue securities activities should be identical to that of broker-dealers and should be provided for specifically in any proposed legislation dealing with these matters. The most significant advantage is the partial deductibility of the carrying costs of municipal bonds. Indeed, eliminating this tax advantage was part of the Treasury's reecommendations for tax reform issued last fall. Eliminating the present bank advantage would enhance Treasury revenues while providing greater competitive equality. The securities industry would accept, although it does not seek, the same advantage as a means of achieving equality.

6. The Bank Holding Company Act should be amended to forbid a securities affiliate from participating in a financing in which any member of the bank holding company complex is participating (e.g., as supplier of a letter of credit or short term financing or acting as bond trustee), and vice versa. A significant unfair advantage for a bank is its ability to tie its credit facilities to its underwriting services. Existing prohibitions against tying arrangements in the Bank Holding Company Act are inadequate to prevent unfairness. All joint

marketing and collaborative efforts involving a securities affiliate and another member of its bank holding company complex should be absolutely barred. The abuse of linking credit facilities to underwriting services (whether between two bank departments or a securities affiliate and a holding company complex member) should be eliminated, regardless of whether a securities affiliate proposal becomes law. The use of credit leverage is unfair and the roles of supplier of credit and underwriter are in direct conflict.

7. If the securities affiliate is to operate under its own authority and by its own skill, it should not benefit from customer and other valuable data constantly flowing into and developed by its affiliated banks. Therefore, a "Chinese wall" should be erected between members of the bank holding company complex and the securities affiliate. Officers and employees in common should not be permitted and directors in common allowed only to the extent permitted in similarly sensitive situations under the Investment Company Act. Exchange of non-public information of a material nature should not be permitted.

8. A securities affiliate should not be permitted to trade on identification with the bank holding company complex. It is clear from past experiences with real estate investment trusts during the 1970's that the public can easily

be confused or misled into believing that bank credit is behind the operations of an affiliate. Such misunderstanding should be avoided to insulate federally insured bank funds and to prevent an unfair benefit of credit identification from being conferred upon the affiliate. A securities affiliate should have a separate and distinguishable name and not be advertised as associated with the bank affiliate, directly or indirectly so as to suggest credit responsibility in the public's mind. For the same reason the securities affiliate should not share premises with any member of the holding company complex. Also, since a securities affiliate could be unfairly subsidized by sharing space or operational facilities, such arrangements should not be allowed. The securities affiliate should bear its own costs and expenses. This may be difficult to police as to allocation of overhead costs, but is vital if Congress is to achieve fair competition.

9. If new underwriting powers are to be granted to bank holding companies or banks, appropriate powers in the field of banking should be granted to securities firms. If competition is deemed to be enhanced by expanded securities powers for banks or bank holding companies, we believe that members of our industry can add significantly to competition in banking and should have the opportunity to do so. To what extent such powers should be given to members of the securities industry depends upon the degree to which Glass-Steagall

principles are abandoned. Should, for example, broad securities powers be given banks, the appropriate enlargement of opportunity for securities firms may well be full powers of a national bank free of all geographic restrictions for all existing securities firms as of the date of enactment. Since the banking community is already well-established with offices and correspondent bank relationships, to be effective the grant of full powers to securities firms should be free of geographic limitations.

10. A carefully phased timetable for institution of any such changes should be worked out in the interests of stability. In order to create fair and equitable competition and opportunity for all, any proposed legislation should deal comprehensively with all matters relating to securities activities of banks and bank holding companies, including the equalization of tax and regulatory treatment, and commercial banking powers for securities firms.

APPENDIX B

Bank Failures During 1984

ALABAMA
Cherokee County Bank, Centre

ARKANSAS
The Corning Bank, Corning
Jackson County National Bank, Tuckerman

CALIFORNIA
Heritage Bank, Anaheim
The National Bank of Carmel, Carmel-By-The-Sea
Garden Grove Community Bank, Garden Grove
Bank of Irvine, Irvine
West Coast Bank, Los Angeles
West Olympia Bank, Los Angeles

COLORADO
Hereford State Bank, Hereford
Farmers State Bank of Holyoke, Holyoke

FLORIDA
Century National Bank, Jacksonville
All American National Bank, Virginia Gardens (P.O. Miami)

ILLINOIS
Washington National Bank of Chicago, Chicago
United of America Bank, Chicago
The Coffeen National Bank, Coffeen
Heritage Bank of Bureau County, DePue
First Security Bank, Sandwich

INDIANA
Peoples State Bank of Clay County, Poland
The Shelby National Bank of Shelbyville, Shelbyville

IOWA
The Farmers National Bank of Aurelia, Aurelia
The Tingley State Savings Bank, Mount Ayr
Oakland Savings Bank, Oakland

KANSAS
The First National Bank of Gaylord, Gaylord
Indian Springs State Bank, Kansas City
The Rexford State Bank, Rexford
The Farmers State Bank, Selden
The Strong City Bank, Strong City
The First State Bank, Thayer
University Bank of Wichita, Wichita

KENTUCKY
Gamaliel Bank, Gamaliel

LOUISIANA
Planters Trust & Savings Bank of Opelousas, Opelousas

MICHGAN
National Bank and Trust Company of Traverse City

MINNESOTA
State Bank of Boyd, Boyd
First National Bank of Prior Lake, Prior Lake
The First National Bank of Rushford, Rushford
Guaranty State Bank of Saint Paul, St. Paul

MISSISSIPPI
The Mississippi Bank, Jackson

MISSOURI
Bucklin State Bank of Bucklin, Bucklin
Republic Bank of Kansas City, Kansas City

NEBRASKA
The Bank of Cody, Cody
David City Bank, David City
Farmers State Bank, Kilgore
Uehling State Bank, Uehling
Bank of Verdigre and Trust Company, Verdigre

NEW JERSEY
Orange Savings Bank, Livingston

OKLAHOMA
First Continental Bank & Trust Company of Del City, Del City
Community Bank and Trust Company, Enid
The Farmers and Merchants Bank, Tecumseh
American State Bank, Thomas
Security State Bank, Weatherford

OREGON
Bank of the Northwest, Eugene
United Bank of Oregon, Milwaukee
First American Banking Company, Pendleton
Stewardship Bank of Oregon, Portland
Emerald Empire Banking Company, Springfield

PUERTO RICO
Girod Trust Company, San Juan

SOUTH DAKOTA
Farmers State Bank, Lyons

TENNESSEE
Coalmont Savings Bank, Coalmont
The Dayton Bank & Trust Company, Dayton
Watauga Valley Bank, Elizabethton
First Security Bank, Erwin
The Lawrence County Bank, Lawrenceburg
Oneida Bank and Trust Company, Oneida
Bledsoe County Bank, Pikeville
American Bank, Saint Joseph
Citizens Bank of Monroe County, Tellico Plains
City & County Bank of Jefferson County, White Pine
Farmers Bank & Trust Company, Winchester

TEXAS
Brownfield State Bank & Trust Co., Brownfield
East Texas Bank & Trust Company, Longview
Security National Bank of Lubbock, Lubbock
American National Bank in McLean, McLean
Seminole State National Bank, Seminole
First National Bank, Snyder

UTAH
Golden Spike State Bank, Tremonton

WEST VIRGINIA
Tucker County Bank, Parsons

WYOMING
Western National Bank of Casper, Casper
State Bank of Mills, Mills

APPENDIX C

Bank Failures During 1983

ALABAMA
Bank of Hackleburg, Hackleburg

ARKANSAS
Prairie County Bank, Hazen

CALIFORNIA
Merchants and Farmers State Bank, Blythe
American City Bank, Los Angeles
The Commercial Bank of California, Los Angeles
Newport Harbour National Bank, Newport Beach
Bank of San Marino, San Marino

COLORADO
Dominion Bank of Denver, Denver

ILLINOIS
Atkinson Trust and Savings Bank, Atkinson
American State Bank, Bradley
Union National Bank of Chicago, Chicago
The First National Bank of Danvers, Danvers
The Ina State Bank, Ina
First National Bank of Oak Lawn, Oak Lawn

KANSAS
The Douglas State Bank, Kansas City

KENTUCKY
Sparta-Sanders State Bank, Sparta

MINNESOTA
State Bank of Barnum, Barnum

MISSOURI
The Madison County Bank, Fredericktown

MONTANA
First National Bank of Browning, Browning

NEBRASKA
Bank of Niobrara, Niobrara, Nebraska.

NEVADA
Mineral Bank of Nevada, Las Vegas

NEW JERSEY
Pan American National Bank, Union City

NEW YORK
Auburn Savings Bank, Auburn
Dry Dock Savings Bank, New York

OKLAHOMA
The Bank of Red Oak, Red Oak

OREGON
Heritage Bank, Ashland
Bear Creek Valley Bank, Phoenix
Columbia Pacific Bank and Trust Company, Portland
Oregon Mutual Savings Bank, Portland
The Deschutes Bank, Redmond

PUERTO RICO
Union Trust Company, San Juan

SOUTH DAKOTA
Community Bank, Hartford

TENNESSEE
Smith County Bank, Carthage
United American Bank in Hamilton County, Chattanooga
United Southern Bank of Clarksville, Clarksville
First Peoples Bank of Washington County, Johnson City
City and County Bank of Roane County, Kingston
City and County Bank of Knox County, Knoxville
United American Bank in Knoxville, Knoxville
City and County Bank of Anderson County, Lake City
Warren County Bank, McMinnville
United Southern Bank of Nashville, Nashville
First Commerce Bank of Hawkins County, Rogersville
The First Central Bank, Smithville
The First National Bank of Midland, Midland, Texas.

TEXAS
Metro Bank, Midland
National Bank of Odessa, Odessa

WYOMING
Western National Bank of Lovell, Lovell

Appendix D

The Protection of Investors: A Regulatory Comparison of the Securities and Banking Industryries

Introduction

The significant changes taking place in the financial services industry have important consequences for the American public as well as for the various segments of the financial services industry. Among the most important issues of concern to the American public, and thus to public policymakers, is the protection afforded to securities investors as depository institutions have become increasingly involved in the securities business. A comparison of the protection currently offered to investors by securities broker-dealers and by banks demonstrates that regulation of bank securities activities in the past has been so permissive as to call into question the advisability of permitting banks to continue to expand into the securities field without significant regulatory reform. A related issue of importance as a public policy matter is the effect of unequal regulatory burdens on the competitive structure of the emerging financial services industry.

This paper will analyze a number of areas where securities and banking industry protections of investors differ, indicating deficiencies in bank protections for securities investors. The public's interest in protecting investors and promoting fair competition through equal regulation demands that banks, if they are to expand their

securities activities, be subject to the same regulatory scheme -- and to the same regulator -- as the nonbank members of the securities industry.

I. Regulatory Background

A. Broker-Dealers

The conduct of securities broker-dealers[1] is governed by statutes administered by the Securities and Exchange Commission (the "SEC"), principally the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"). To ensure compliance with these statutes, registered broker-dealers are subject to periodic inspection by the so-called "self-regulatory organizations" to which they belong, such as the New York Stock Exchange (the "NYSE") and the National Association of Securities Dealers, Inc. (the "NASD"). The SEC has statutory responsibility for overseeing the rules and operations of the self-regulatory organizations and also conducts inspections of broker-dealers. Statutory requirements are supplemented by SEC rules and regulations, and by the rules and regulations of the self-regulatory organizations. Broker-dealers are thus subject

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1/ See Securities Exchange Act of 1934, Section 3(a)(4), 15 U.S.C. § 78c(a)(4) (definition of the term "broker"); Securities Exchange Act of 1934, Section 3(a)(5), 15 U.S.C. § 78c(a)(5) (definition of the term "dealer").

to a single, integrated regulatory system under the centralized authority of the SEC.

Specific substantive safeguards with regard to broker-dealer activities include obligations for broker-dealers to maintain minimum net capital (usually calculated on a daily basis), to furnish customers with detailed confirmations of purchases and sales, to furnish customers with periodic statements of account, to ensure the protection of customer funds and securities through contributions to the Securities Investor Protection Corporation ("SIPC"), to bond employees, and to maintain a detailed set of books and records. Broker-dealers must also comply with rules governing the appropriateness of advertising materials and other disclosures to customers, the suitability of securities investments for customers and the supervision of personnel.

The principal aim of this regulatory pattern is to promote the protection of investors, to provide full and fair disclosure of the character of securities sold, to prevent fraud in the sale of securities, and to prevent inequitable and unfair practices in the securities markets.

B. Banks

In contrast to broker-dealers, commercial banks are subject to a number of different regulatory schemes, depending upon whether the banks have state or federal charters, whether they are members of the Federal Reserve System and whether

their deposits are federally insured. Banks that are federally chartered -- national banks -- are subject only to the supervisory and examination authority of the Comptroller of the Currency (the "Comptroller"). All other domestic banks are chartered, supervised and examined by state banking authorities. State-chartered banks also are subject to the federal oversight authority of the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), in the case of banks which are members of the Federal Reserve System, or of the Federal Deposit Insurance Corporation (the "FDIC"), in the case of state banks which have not joined the Federal Reserve System.[2]

Each of the federal bank regulatory agencies has its own separate statutory and regulatory requirements designed to insure the financial safety of the banks subject to its supervision. Federal bank supervisory bodies have adopted few uniform regulations or standardized compliance and inspection procedures.

The system of federal bank regulation developed from the recognition that banks play a pivotal role in our nation's monetary system, and that their collapse would have significant

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2/ As a practical matter, very few state banks operate in the United States without becoming members of the Federal Reserve System or obtaining FDIC insurance for deposits.

adverse effects on the economic well-being of the entire nation. The principal focus of banking regulation, therefore, is on the protection of depositors and the preservation of the financial soundness and stability of banks, not on the protection of securities investors.

While bank securities services are competitive with services offered by broker-dealers, securities regulations designed to protect investors do not apply equally to both banks and broker-dealers. As instructed by Congress, the SEC addressed this problem in its Report on Banks' Securities Activities (the "SEC Bank Study").[3/] The SEC Bank Study identified a number of areas in which bank services equivalent to those offered by broker-dealers do not appear to be subject to adequate regulation. Although the federal banking agencies have adopted some of the SEC's recommendations, the disparity of substantive regulation continues, as discussed below. Moreover, no amount of regulation can eliminate the potential for disparity of treatment that may arise when different regulators -- with different regulatory objectives -- oversee similar activities.

3/ Senate Committee on Banking, Housing and Urban Affairs, 95th Cong., 1st Sess., Report on Banks' Securities Activities of the Securities and Exchange Commission, Pursuant to Section 11A(e) of the Securities and [sic] Exchange Act of 1934 (Public Law 94-29) (Comm. Print 1977).

II. Differences in Substantive Requirements

The two disparate regulatory approaches discussed above have produced two separate regulatory systems, with the result that in a number of important areas banks and broker-dealers are not regulated equally. The most important of these are discussed below.

A. Qualification and Supervision Requirements for Securities Personnel

A principal reason for requiring registration of broker-dealers and associated persons is to impose certain minimum standards of competence upon persons who hold themselves out as qualified to perform securities services. All persons associated with a broker-dealer, other than employees with purely clerical of ministerial duties, are tested for competence by being required to take and pass a qualification examination covering substantive aspects of the securities business and its legal requirements.[4] The NASD and the principal stock exchanges also require that persons actively involved in the management of any member broker-dealer

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4/ See, e.g., NASD By-Laws, Schedule C, NASD Manual (CCH) ¶ 1102A (1983); NYSE Rules 304A, 345, 2 New York Stock Exchange Guide (hereinafter "NYSE Guide") (CCH) ¶¶ 2304A, 2345 (1983).

pass additional examinations relating to supervisory procedures and requirements.[5] Moreover, broker-dealers are under an affirmative obligation to inquire into the good character and background of their employees.[6]

These competency requirements are buttressed by provisions of the Exchange Act which require broker-dealers to supervise their personnel with a view to preventing violations of the federal securities laws.[7] More importantly, both the SEC and the various self-regulatory organizations have adopted specific rules detailing required supervisory procedures. For example, these rules require the prompt review of all transactions and correspondence of registered representatives and the frequent examination of holdings in customer accounts.[8] The purpose of the supervisory procedures is to assure that broker-dealer employees act at all times in accordance with the securities laws. Failure to supervise employees adequately can result in limitation or

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5/ Id.

6/ See, e.g., NASD Rules of Fair Practice, Art. III, Sec. 27(e), NASD Manual (CCH) ¶ 2177 (1983); NYSE Rule 345.18, 2 NYSE Guide (CCH) ¶ 2345.18 (1983).

7/ Exchange Act § 15b(4)(E), 15 U.S.C. § 78b(4)(E) (1982).

8/ See, e.g., NASD Rules of Fair Practice, Art. III, Sec. 27, NASD Manual (CCH) ¶ 2177 (1983); NYSE Rules 342.16, 405(2), 2 NYSE Guide (CCH) ¶¶ 2342.16, 2405(2) (1983).

termination of a broker-dealer's securities activities.[9] Bank personnel, on the other hand, are subject to no testing or licensing requirements or to any specific federal regulations governing their substantive knowledge of the securities business or its legal requirements. Moreover, although regulations do require banks to assign supervisory responsibility over personnel who place orders or execute securities transactions, no particular supervisory procedures are specified.[10]

Ultimately, evaluation of the competency of bank personnel and the adequacy of a bank's supervisory procedures depends on a subjective determination by a bank examiner. Each of the bank regulatory agencies nominally addresses the importance of generally competent management and staff in its examination procedures. For example, the "Comptroller's Handbook for National Trust Examiners" (the "Trust Handbook") requires a bank trust examiner, when evaluating the quality of management, to consider, among other things, management's education, training, experience, and proficiency in various

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9/ See, e.g., NYSE Rule 342.14, 2 NYSE Guide (CCH) ¶ 2342.14 (1983).

10/ 12 C.F.R. § 12.6 (1983) (Comptroller); 12 C.F.R. § 208.8(k)(5) (1983) (Federal Reserve Board); 12 C.F.R. §344.6 (1983) (FDIC).

areas, including an understanding of the securities laws.[11] Moreover, with respect to any specialized securities trading personnel, an examiner is directed by the Trust Handbook to evaluate each such person's knowledge of the securities markets, the securities laws and certain trading activities. In neither case, however, is a method for objectively evaluating an employee's securities expertise specified, nor is the examiner likely to have a good "feel" for this subject matter, since the examiner is neither required nor likely to have securities expertise. The Federal Reserve Board and the FDIC provide even less guidance in their examination manuals for assessing the competence of securities personnel.[12]

A few management standards which do exist in the banking industry are de minimus and have no relevance to particular dangers presented by securities transactions. The subjective approach taken by the Federal bank regulators to questions of managerial character and competence is illustrated by the guidance offered by the FDIC:

11/ Comptroller of the Currency, Comptroller's Handbook for National Trust Examiners 57-58 (1981).

12/ See, e.g., Division of Bank Supervision, Federal Deposit Insurance Corporation, Manual of Examination Policies, § L at 1.

> The quality of management is probably the single most important element in the successful operation of a bank. For purposes of this section, "management" includes both the board of directors, which is elected by the shareholders, and executive officers, who are appointed to their positions by the board. In the complex, competitive and rapidly changing environment of financial institutions, it is extremely important for all members of bank management to be aware of the responsibilities entrusted to them and discharge those responsibilities in a manner which will ensure stability and soundness of the institution, so that it may continue to provide its community the financial services for which it was created.[13]

B. Substantive Requirements Governing Securities Operations.

Protection of Customer Funds and Securities. In addition to the lack of specific standards regarding supervision and personnel, banks are also free from a number of important substantive investor protection safeguards required for broker-dealers. For example, the Securities Investor Protection Act of 1970, which created SIPC, requires annual contributions by all broker-dealers having public customers and provides specific protection for the funds and securities of customers of brokerage firms that become insolvent and are forced to liquidate.[14] A broker-dealer customer may seek

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13/ FDIC, Manual of Examination Policies § L at 1.

14/ 15 U.S.C. § 78aaa et seq. (1982).

the return of all specifically identifiable securities or other property belonging to him, as well as up to $500,000 in property that is not specifically identifiable ($100,000 of which may be a claim for cash). Banks are not covered by SIPC. While the FDIC insures deposits of bank customers in the event of an insured bank's failure, FDIC insurance does not extend to securities held in the bank's possesion on behalf of a customer.[15] An investor utilizing the securities services of a bank rather than a broker-dealer therefore could be subject to market fluctuations in the value of his securities pending settlement of a defunct bank's liabilities and even lose his investment altogether.

As a further protection for customer funds and securities, broker-dealers are required to maintain blanket fidelity bonds insuring against a variety of risks, including loss through any dishonest or fraudulent act of any employee and loss of property (including securities) through misplacement, forgery, or fraudulent trading.[16] The

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15/ 12 U.S.C. § 1813(1) (1982).

16/ See, e.g., Exchange Act Rule 15b10-11, 17 C.F.R. § 240.15b10-11 (1983); NASD Rules of Fair Practice, Art. III, Sec. 32, Appendix C, NASD Manual (CCH) ¶¶ 2182, 2182A (1983).

amount of coverage required increases with the broker-dealer's net capital requirements. Bonding requirements for banks are more generalized. The Comptroller's regulations specify no particular amount of fidelity coverage for national bank employees,[17] while the FDIC has only an informal policy concerning the amount of fidelity coverage required for insured state banks.[18]

Margin Regulation. The margin requirements governing the extension of credit for securities purchases also apply unequally to broker-dealers and banks. Broker-dealers are subject to a number of restrictions on their loans to investors to purchase securities that do not apply to banks. First, broker-dealers may make unsecured loans to investors only where such loans are expressly represented by the investors not to be for the purpose of acquiring securities.[19] Second, when broker-dealers make loans to investors to purchase securities, "exempted"[20] or "margin"[21] securities must be pledged as

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17/ 12 C.F.R. § 7.5215 (1983).

18/ FDIC, Manual of Examination Policies § P at 1.

19/ 48 Fed. Reg. 23,169 (1983) (to be codified at 12 C.F.R. 220.9(a)(3)).

20/ Exchange Act § 3(a)(12), 15 U.S.C. § 78C(a)(12) (1982).

21/ 48 Fed. Reg. 23,167 (1983) (to be codified at 12 C.F.R. §220.4(c)(2)).

collateral.[22] Third, broker-dealers are subject to margin requirements on loans to purchase any securities, regardless of types of securities being purchased.[23]

In contrast, banks are subject to relatively few constraints on their securities lending activities. Banks are not prohibited from making unsecured loans to purchase securities.[24] Second, banks are not limited to accepting only exempted or margin securities as collateral for loans to purchase securities.[25] Third, banks are subject to margin requirements only as to purchases of "margin stock", i.e., certain specified equity securities, and only to the extent margin stock is pledged as collateral; loans by banks to purchase margin stock that are secured by debt securities or other collateral are not subject to margin requirements.[26]

22/ Exchange Act § 7(c), 15 U.S.C. §78g(c) (1982).

23/ 48 Fed. Reg. 23,167 (1983) (to be codified at 12 C.F.R. §220.4(b)).

24/ Cf. Exchange Act § 7(c), 15 U.S.C. §78g(c) (1982) with Exchange Act § 7(d), 15 U.S.C. §78g(d) (1982).

25/ Id.

26/ Exchange Act § 7(d)(D), 15 U.S.C. §78g(d)(D) (1982); 48 Fed. Reg. 35,077 (1983) (to be codified at 12 C.F.R. § 221.3(a)).

The effect of these considerably different margin requirements is clear. At every turn, banks are able to finance the credit needs of securities investors much more easily than broker-dealers. Banks need not require collateral; when they do, qualifying securities need not be posted as collateral; and the margin requirements apply only to the extent purchases of margin stock are secured by margin stock. Even apart from issues of competitive equality, as banks aggressively seek to market their brokerage services to the general public, the result may be that investors will be encouraged to take substantial securities positions not justified by their resources. The final consequence could well be the type of excessive speculation in securities that was an important cause of the stock market crash of 1929, injuring not only investors served by banks but all securities investors.

Advertising. Broker-dealers must also comply with specific guidelines concerning the content and review of advertisements.[27] With certain limited exceptions,[28]

27/ See, e.g., NASD Rules of Fair Practice, Art. III, Sec. 35, NASD Manual (CCH) ¶ 2195 (1983).

28/ 12 C.F.R. § 9.18(b)(5) (1983) (Comptroller: advertising of common trust funds); 12 C.F.R. § 225.125(h) (1983) (Federal Reserve Board: advisory services for investment companies).

there are no equivalent rules governing the advertisement of bank securities services. Although bank examiners do review promotional literature published by banks in an effort to uncover violations of the banking laws (e.g., payment of excessive interest rates), examiners generally are not charged with looking for unfair or misleading advertising relating to the performance of brokerage services.

Suitability. Among the more important protections for investors is the "suitability" rule, which requires that a broker-dealer, when recommending a security to a customer, have a reasonable basis for believing that the security is suitable for that customer in light of the customer's investment objectives, financial situation and needs.[29] By contrast, there is no comparable regulatory requirement applicable to bank brokerage activities. Banks are subject to certain general fiduciary obligations in dealing with their customers, but these would not impose as stringent an affirmative duty as the suitability standard.

Prompt Execution. Execution of securities investor trading orders is another area where banking regulations offer scant protection. Broker-dealers are required by the securities laws to execute customer orders within a reasonable

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29/ Exchange Act Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1983); NASD Rules of Fair Practice, Art. III, Sec. 2, NASD Manual (CCH) ¶ 2152 (1983).

time period, when possible, which in the case of publicly traded securities is generally a matter of minutes. Banks, on the other hand, have significantly more leeway. For example, the Comptroller permits national banks to take up to one year or more to invest customer funds.[30]

Recordkeeping and Confirmations. Finally, the rules adopted by the SEC under the Exchange Act contain extensive requirements governing recordkeeping and confirmation of securities transactions by broker-dealers.[31] Although the federal banking agencies adopted some recordkeeping and confirmation rules in response to recommendations of the SEC Bank Study,[32] there are a number of discrepancies between these rules and the rules of the SEC. For example, the SEC's confirmation rule requires that broker-dealers generally must send customers written confirmation of a securities

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30/ Comptroller's Handbook for National Trust Examiners, Precedents and Opinions § 9.3100. In the meantime, funds so held by national banks may be invested in time deposits or treasury bills. While the rates of return on such interim investments may be adequate, any delay in executing orders would defeat customer intent and subject the customer to unwarranted market risk.

31/ Exchange Act Rules 15b10-6, 10b-10, 17 C.F.R. §§ 240.15b10-6, 240.106-10 (1983).

32/ 12 C.F.R. § 12 et seq. (1983) (Comptroller); 12 C.F.R. § 208.8(k) (1983) (Federal Reserve Board); 12 C.F.R. § 344 et seq. (1983) (FDIC).

transaction within five days.[33] The rules of the bank agencies provide several exceptions to this requirement that are not present in the SEC's rules, such as permission for confirmations within an unspecified "reasonable time" where the bank exercises investment discretion over an account in an agency capacity.[34] Moreover, the rules of banking authorities tend to be considerably less specific than those of the SEC, in many cases relying on reference to "sound banking practices" rather than the more specific regulations applicable to securities firms.

The differences in substantive regulation of banks and broker-dealers cited above become even more significant when banks go beyond merely performing accommodation transactions for customers and actively being to solicit securities brokerage business. As greater numbers of investors use banks to execute securities transactions and perform other securities-related functions, increased transaction volume may put considerable strain on the ability of banks to carry out their obligations adequately and safely, particularly in the

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33/ Exchange Act Rule 10b-10(c), 17 C.F.R. § 240.10b-10(c) (1983).

34/ 12 C.F.R. § 12.5(c) (1983) (Comptroller); 12 C.F.R. § 208.8(k)(4)(iii) (1983) (Federal Reserve Board); 12 C.F.R. § 344.5(c) (1983) (FDIC).

absence of well-defined regulatory guidelines. The nearly inevitable result will be diminished protection for securities investors serviced by banks.

III. Differences in Regulatory Procedures and Policies.

The principal discrepancies in the regulation of banks and broker-dealers arise from the fact that banks and broker-dealers are subject to the jurisdiction of different regulators with different regulatory philosophies and objectives. Even if substantive requirements were similar, differences in enforcement policies and procedures can lead to regulatory inequality.

As discussed above, the primary focus of the federal securities laws is the protection of investors. To this end, the SEC and the self-regulatory organizations have broad authority to institute administrative action with respect to broker-dealers and associated persons for violations of the Federal securities laws and other enumerated offenses, including placing limitations on their activities or suspending or revoking their registrations.[35/] Sanctions may be imposed on individuals who have violated legal or ethical standards even though their misconduct has no direct financial

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35/ Exchange Act § 15(b), 15 U.S.C. § 78o (1982).

consequence for the broker-dealer or its customers, e.g., willful violations of SEC recordkeeping requirements.[36]

In contrast, the principal concern of federal bank regulators is to assure the safety and soundness of the banking system. Their statutory mandate gives priority to protection of the financial security of banks and their depositors over the protection of investors. For example, the federal bank agencies have broad powers to initiate cease and desist proceedings against insured banks for unsafe and unsound practices or violations of the banking laws and regulations.[37] Temporary cease and desist orders may be issued only if the agency determines that the violations are likely to threaten the solvency of the bank or prejudice the interests of depositors.[38] Similarly, directors and officers of a bank may be removed if their misconduct (i) causes or will probably cause substantial financial loss or damage to the bank, prejudice to depositors or financial gain to the officer or director and (ii) involves personal dishonesty

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36/ Exchange Act Rule 15b10-6, 17 C.F.R. § 240.15b10-6 (1983).

37/ 12 U.S.C. § 1818(b)(1) (1982).

38/ 12 U.S.C. §1818(c) (1982).

or a willful or continuing disregard for the safety or soundness of the bank.[39]

This difference in regulatory purpose is also evidenced by the differences in SEC and bank agency enforcement proceedings. A major thrust of the securities laws is full disclosure, and SEC administrative proceedings are permitted to be and generally are conducted in public.[40] In contrast, bank regulators are concerned about the need for public confidence in banks and therefore tend more toward confidentiality in their administrative proceedings. Indeed, the banking laws provide that hearings relating to the issuance of cease and desist orders or the removal of officers or directors be conducted in private unless the banking agency determines a public hearing is necessary to protect the public interest.[41]

The discrepancy inherent in these two different regulatory approahes was summarized by then Commissioner John R. Evans of the SEC:

39/ 12 U.S.C. § 1818(e) (1982).

40/ See Exchange Act § 22, 15 U.S.C. §78v (1982) ("Hearings [by the SEC] . . . may be public . . ."); SEC Rules of Practice, 17 C.F.R. § 201, et seq. (1983).

41/ 12 U.S.C. § 1818(h)(1) (1982).

> [B]ank regulatory authorities have a different enforcement orientation than that of the Commission, placing greater reliance on informality and confidentiality, or to be more blunt, secrecy in enforcement actions. This basic enforcement principle may be appropriate in the traditional area of bank regulation designed primarily to protect depositors, but we do not consider it to be appropriate in the area of protecting investors from misconduct on the part of dealers, who have been found to have violated legal and ethical standards in their activities as securities professionals. The Commission should not be fettered by this basic bank regulatory enforcement principle where serious misconduct involving securities activities is involved, particularly since equality of enforcement cannot be attained if disciplinary action against one segment of a competitive industry is to remain secret while enforcement against another segment is subject to public disclosure.[42]

A difference in regulatory approach is also evident in the compliance efforts of the SEC and bank agencies. The primary focus of bank examiners is upon mattes which may affect bank solvency, not upon compliance with the federal securities laws or investor protection.

For example, although trust examiners of the Comptroller are required to make several specific inquiries regarding a bank's securities operations, the primary focus of the trust department examination remains on the soundness of

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42/ Hearings on S.1933 and S.2474 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 93d Cong., 2d Sess. 54 (1974).

the bank. While the Comptroller recognizes an obligation to protect fiduciary beneficiaries, it is only because such protection is viewed as being "essential to the protection of the bank, its depositors and shareholders."[43] Moreover, neither the Federal Reserve Board nor the FDIC has promulgated any specific standards with respect to review of securities operations of state bank trust departments.

A similar distinction exists in the compliance examinations conducted with regard to corporate financing services provided by both banks and broker-dealers. A major purpose of broker-dealer examination in this area is to determine whether private placement transactions are effected in compliance with the federal securities laws. Bank examinations, on the other hand, focus principally on whether a bank's securities activities are likely to affect the safety and soundness of the bank and not on whether there is an available exemption from the federal securities laws.[44]

Although the difference in regulatory focus between securities and banking regulators is not difficult to under-

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43/ Comptroller's Handbook for National Trust Examiners, p. 1.

44/ SEC Bank Study at 327, 419.

stand, beyond question it produces unequal investor protection. Even if the banking regulators were to administer statutes and regulations governing bank securities activities identical to those used by the SEC in supervising nonbanking firms, the divergence in regulatory goals between the bank regulators on the one hand, and the SEC and the various self-regulatory organizations on the other and, on a practical level would result in dissimilar administration of the securities laws. The fundamental principles of investor protection embodied in the securities laws demand that such laws be applied consistently, and without regard to conflicting regulatory goals, whenever invt in dissimilar administration of the securities laws. The fundamental principles of investor protection embodied in the securities laws demand that such laws be applied consistently, and without regard to conflicting regulatory goals, whenever investors risk their funds in the securities markets. As the federal regulator primarily charged with protection of securities investors, the SEC clearly is best able to enforce the securities laws consistently and vigorously.

IV. Conclusion

Bank securities activities, like comparable activities of broker-dealers, raise concerns as to the adequate protection of investors and the operation of fair and efficient securities markets. The above discussion demonstrates that there are material divergences between the two separate regulatory

schemes for banks and broker-dealers. While the discrepancies might not be significant were banks to maintain a limited role in the securities business, the effects of unequal regulation become more pronounced as competition between banks and broker-dealers expands into new areas of activity and bank securities services become widely and aggressively promoted and used by the public. Permitting banks to expand their securities activities without comparable regulation cannot be sound public policy.

In addition to concerns about investor protection, failure to subject banks to the same regulation imposed upon non-banks conducting similar activities would provide them an unfair advantage over their competitors. Under the current regulatory structure, banks subject to less extensive regulation of their securities activities ultimately realize cost savings that give them an artificial advantage over broker-dealers in the marketplace. Moreover, the less stringent regulations faced by banks allow them to respond to market opportunities more quickly and easily than securities firms. It cannot have been the intent of Congress, in exempting banks from the definitions of "broker" and "dealer" in the Exchange Act, to permit them to challenge competitors who have one hand tied behind their backs.

Congress has designated the SEC, together with the self-regulatory organizations, as the regulatory authority for the securities business. The SEC's statutory framework, rules, expertise, and examination and enforcement procedures -- not

Answers to Questions
from Senator Garn
Relating to Testimony of
Robert F. Shapiro on June 20, 1985

1. We must differ with your characterization of commercial paper as a securitization of the short-term commercial loan market. Commercial paper is a security that has been actively used by corporate issuers for over 50 years. Both markets have developed along parallel growth paths in recent years. From August 1977 to August 1984, both the commercial paper market and the short-term commercial loan market enjoyed exceptional growth.[1/] Total commercial paper outstanding grew 268.8% from $60.3 billion to $222.4 billion over the period (See Table I). However, growth in the short-term commercial and industrial loan market outpaced the commercial paper market, increasing 351.9% from $8.2 billion to $37.0 billion according to the Federal Reserve's periodic survey (See Table II).

As of August 1984, the relative proportion of commercial paper offered by financial versus nonfinancial companies was almost the same as in August 1977. Moreover, the proportion varied little over the 1977-84 period.

1/ Latest period for which comparable data is available

Financial company paper comprises over 70% of the total outstanding, and nonfinancial paper accounts for just under 30%. There has, however, been a distinct shift in the magnitude of short-term bank loans. Large bank loans, over $500,000, now account for 87% of all short-term commercial loans, compared with 47% in 1977.

Table I

Commercial Paper Outstanding
($ Billions)

	Financial Companies[2/]		Nonfinancial Companies[3/]		Total
	$	%	$	%	$
August 1977	44.9	74.4	15.5	25.7	60.3
August 1978	56.4	76.2	17.6	23.8	74.0
August 1979	77.8	74.9	26.1	25.1	103.9
August 1980	83.6	68.2	39.0	31.8	122.6
August 1981	108.6	69.1	48.5	30.9	157.1
August 1982	119.8	67.6	57.4	32.4	177.2
August 1983	131.4	75.2	43.3	24.8	174.7
August 1984	160.8	72.3	61.6	27.7	222.4

Note: Detail may not add to total due to rounding

Source: Federal Reserve Bulletin

2/ Institutions engaged primarily in activities such as, but not limited to, commercial, savings, and mortgage banking; sales, personal, and mortgage financing; factoring, finance leasing, and other business lending; insurance underwriting; and other investment activities.

3/ Includes public utilities and firms engaged primarily in such activities as communications, construction, manufacturing, mining, wholesale and retail trade, transportation, and services.

Table II

Short-Term
Commercial & Industrial
Bank Loans by Size
($ Billions)

	Under $50,000		$50,000 to $500,000		Over $500,000		Total
	$	%	$	%	$	%	$
August 1977	1.6	19.0	2.8	34.2	3.8	46.8	8.1
August 1978	1.6	22.4	2.5	35.3	3.1	42.4	7.1
August 1979	1.4	16.9	1.9	22.5	5.0	60.6	8.2
August 1980	1.2	8.9	2.8	20.6	9.5	70.5	13.5
August 1981	1.5	5.8	3.4	13.9	20.3	82.7	2[illegible].6
August 1982	1.6	4.3	2.8	7.5	33.2	88.3	[illegible]7.6
August 1983	1.6	4.4	3.2	8.8	32.0	86.8	36.8
August 1984	1.6	4.3	3.2	8.6	32.2	87.1	37.0

Note: Detail may not add to total due to rounding

Source: Board of Governors of the Federal Reserve System, "Survey of Terms of Bank Lending"

The trend toward securitization of mortgage, automobile and consumer loans will most likely continue. It should be noted, however, that the fastest expanding portion of the mortgage market is in mortgage backed securities pooled and insured by the Government National Mortgage Association, Federal National Mortgage Association and Federal Home Loan Mortgage Corporation. Both banks and broker dealers participate in this market. Privately-backed mortgage securities, issued only by broker dealers, comprise a very small portion of the total mortgage market. For example, privately-backed securities issued in the period 1980 through 1983 comprised less than 1% of the total $1.8 trillion of mortgage debt outstanding at year-end 1983.

Not only do banks participate in the agency issued mortgage market, but the bulk of pooled mortgages originate with savings institutions and banks. This market serves to relieve these institutions from the financing of loans through deposits gathered locally. The result is the emergence of a national mortgage market fed by a growing pool of money that, in effect, dispatches financing to those states and regions where home sales might be booming.4/

We believe this trend toward "securitization" has a favorable impact on all financial institutions as well as

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4/ "Rise of a National Mortgage Market", New York Times, 1/22/84.

the consumer. Well-managed banks should be able to more closely match assets and liabilities, in addition to turning over fee generating assets more quickly. Securitization of loans also shifts short- and long-term interest rate risks to institutions and investors. The results should be an enhancement of bank profits.

Commercial banks provide the raw materials for these securities. Bankers could eliminate these securities by refusing to have the raw material securitized by a broker/dealer and distributed to the public, but obviously bankers have found the process beneficial as noted above.

2. High yield bonds are once again instruments that have existed in the securities market for a long period of time and do not represent a securitization of the middle market commercial bank loans. These securities differ substantially from bank loans since they are of longer maturity, are at fixed rates and have substantial different covenants. The written testimony of Robert E. Linton delivered to the Senate banking committee on June 20, 1985, details these differences. They are not part of any "trend" but are simply one of the traditional means corporations may use for financing.

3. The trend toward securitization of certain bank loans began a few years ago. However, while new instruments have been developed, there does not appear to be any lessening

of commercial bank share of overall loan markets or insured deposits. For example, despite the rapid growth in money market funds in the 1980s, checkable deposits, currency and time and savings deposits represented 34% of households total financial holdings in 1980 and 34% in 1984, having waned only minimally in the intervening years.

There is also little evidence that the commercial banking industry has been adversely affected in recent years by the development of new securities products as seen by the attached table. The after-tax ROE for the commercial banking industry has been relatively stable, and over the period many banks have reported increased earnings and record profits. (Table III)

Table III

Comparison of After-Tax Return on Equity (ROE) in Securities and Banking Industries, 1973-1984

	Commercial Banking After-Tax ROE
1974	12.59%
1975	11.75
1976	11.48
1977	11.71
1978	12.90
1979	13.90
1980	13.68
1981	13.12
1982	12.08
1983	11.12
1984	10.68
Standard Deviation	1.0

Sources: Securities Industry Association and American Bankers Association

4. There has been much attention focused on financial planning as well as the one-stop financial supermarket. Although the one-stop financial supermarket has been labeled by some observers as the "wave of the future", the difficulties of certain major financial organizations in making multi lines of business profitable has been well-publicized. Recently, I believe there has been a good deal of rethinking on the concept of one-stop financial shopping. Importantly, according to an Arthur Andersen/SIA study of the future of the securities industry, customers are not convinced that variety of products is the most important factor in choosing a financial service provider.5/ Individuals polled choose variety of products as the fourth consideration out of six. It is interesting to note that the securities industry and its competitors (consisting of banks, insurance companies, etc.) believe that variety of products is the second most important determining factor for the retail customer.

5. The Board of Directors of the securities industry is divided on the question of grandfathering or divesting nonbank banks. At the present, we lack a consensus on the subject and we would suggest that this question is best

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5/ Keys to A Changing Securities World, Arthur Andersen & Co. and SIA, 1985 - A copy is included

asked of individual members of the securities industry. However, the overwhelming majority of the securities industry believes that the Glass-Steagall Act separation is as valid today as when it was passed and urged strengthening and clarifying that Act in order to reestablish legislative policy to be followed by the bank regulators. As far as we are aware, there has been no litigation instituted by either banks, their trade associations or their regulators claiming that any product or service provided by the securities industry violates any existing banking or securities legislation so, therefore, we see no legal foundation for divesting any products or activities currently used or sold by the securities industry.

Regarding areas in which competition should be permitted to continue between banks and securities firms, Glass-Steagall originally allowed for limited competition in government and municipal general obligation securities. The fundamental principle of that Act was that commercial and investment banking should be separate and not competitive. This remains sound public policy.

6. In order to create symmetry, bank entry into the securities business should occur at the same time that the securities industry enters the business of banking. This would require the elimination of the McFadden Act and Douglas amendment restrictions on branching, the

elimination of the Glass-Steagall Act and the imposition of the Securities Act of '33, Exchange Act of '34, Investment Company Act of '40, Investment Advisor Act of '40 on banks, their subsidiaries and affiliates. If a separate subsidiary approach is adopted in order to expand bank holding company activities, we believe that the 10 points to which we testified on February 12, 1982, before the Subcommittee on Securities of the full Senate Committee on Banking, Housing and Urban Affairs provides a framework to replace the absolute prohibitions of the Glass-Steagall Act. As we have said many times in the past, we do not endorse either of these approaches. We continue to believe that commercial banks are unique and fulfill a unique role in our society. The current laws create a line separating commercial banking from the rest of commerce and we believe that line remains valid today.

7. The size of the nonbank banks created by some of our members and related banking activities remain relatively small to the securities activities they conduct. Therefore, we believe it highly unlikely that mistakes in their limited banking activities would jeopardize the parent securities firm or the banking system. In contrast, money center banks have indicated that they would like to be major players in buying and selling securities and in underwriting activities. The principal business, in particular, is among the most risky in the securities industry. It is entirely possible that on an

extensive scale, banks' securities activities could incur sizeable losses, jeopardizing their banking operations as well.

8. There are no figures available on the profitability of different product lines. Indeed, most publicly owned firms make it a point to stress that they are unable to estimate profits by different product lines because of the difficulty of allocating costs and capital by specific product line.

Based on experience, most industry observers would agree that the agency business, where the broker does not put any capital of the firm at risk, is a relatively low risk activity. In contrast, when firms act as market-makers or principals and place their own capital at risk, these are considered among the riskiest activities at securities houses.

9. While we applaud your efforts in creating the new 23B of the Federal Reserve Act in your legislation last year, it did not resolve the problems of transactions between commercial banks and its securities affiliates. Both 23A and 23B are very porous in that regulatory standards have not been developed and the statutory language leaves the regulators with broad leeway. 23B would be particularly difficult to enforce given regulators would have to determine whether a specific transaction is done at

arm's-length and is similar in terms to other lending transaction in the market. In addition, there appears to be little enforcement of 23A by bank regulators today, and we doubt there would be a high level of enforcement of 23A or 23B if enacted.

10. We believe that this question mischaracterizes our testimony. We acknowledge that there has been a blurring between some of these traditional lines of intermediaries, and we call for a total reexamination of all of the laws that regulate the financial services industry. We believe that the reexamination will demonstrate the continued usefulness of the Glass-Steagall Act separation. If the Congress agrees, certain loopholes in the Glass-Steagall Act and the Bank Holding Act will need to be closed in order to reestablish the clear separation between commercial banking and investment banking. We are not advocating any piecemeal approach, rather a comprehensive reexamination with a concurrent change in all laws required to create the financial services industry of the future.

Add to Proxmire Section

The trend towards internationalization of securities market began in the early 1970s and has been moving forward relatively quickly. The seven issues outlined in Senator

Proxmire's questions are exceedingly important and the Securities and Exchange Commission has begun a timely examination of these issues. The securities industry along with corporate issuers, exchanges both domestic and foreign, institutional investors, and individual investors should all play a role in examining these issues, and developing a plan for the future. We look forward to working with the Commission and the Congress in the process of identifying problems and finding solutions. We believe that the development of a international equity market will be a fairly long evolutionary process much like the development of a national market system has been. There are many who believe that the fixed income markets have already been internationalized given the size of the Eurobond market and the extent of U.S. offerings overseas and now, with the elimination of the withholding tax, the acceleration of this development. Since debt instruments can be traded more like commodities than equities, it is not surprising that the internationalization of the fixed income markets has progressed so rapidly.

INVESTMENT COMPANY INSTITUTE

DAVID SILVER
President

July 22, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
534 Dirksen Building
Washington, D. C. 20510

Dear Mr. Chairman:

Due to the vagaries of the mails, we did not receive until July 10 your letter of July 1 containing questions arising from the recently completed hearings on changes in the financial services industry. Nevertheless, in recognition of your desire to close the hearing record promptly, we have made every attempt to respond as quickly as possible. I would emphasize that these are mainly personal reactions as it has not been feasible to elicit a variety of industry views nor to do extensive research.

We would make one general observation: many of your questions address concepts and incorporate terminology such as "securitization" and "junk bonds," which were not even terms of general usage in the financial industry ten years ago. On the one hand, this highlights the point that you have made: that the financial marketplace continues to evolve on its own. However, these developments also highlight a point we have long made: that a broad legislative approach to developments in the financial services industry seems preferable to piecemeal change.

Pursuing a narrow approach will have two negative effects. First, the Congress will be denied a comprehensive overview of the financial services industry -- an overview which must precede any fundamental determination as to whether or not an integrated financial

services industry represents sound public policy. Second, a narrow approach will enmesh the Congress in an endless effort to balance the seesaw between the various sectors of the financial services industry as these competitors continue to develop new products and discover new loopholes.

If we can be of further assistance, please do not hesitate to call us.

With every good wish, I remain

Sincerely yours,

David Silver

David Silver
President

QUESTIONS FOR MR. SILVER FROM SENATOR GARN

1.Q. The commercial loan market has been "securitized" through the development of commercial paper. The mortgage loan market is being "securitized" through the development of mortgage backed securities. Some are starting to securitize automobile loans.

Do you agree with the forecasts of increasing "securitization" of loan markets? If so, what will this imply for the structure of financial institutions?

A. The recent phenomenon of securitization -- the pooling of loans and the issuance of shares in the pool to investors -- has become increasingly important in recent years. Depository institutions play an important part in the securitization process in that they direct loans into such pools.

The impetus for securitization probably arises from multiple sources. First, technology and the standardization of loan instruments has facilitated the marshalling of like assets into large portfolios and the distribution of interests in these portfolios to millions of investors. Second, depository institutions have moved to participate actively in the securitization process in an effort to maximize liquidity and avoid long-term interest rate exposure. By selling loans rather

than holding them to maturity, depository institutions may free assets for use in other activities, reduce the need for additional capital, and may increase profitability. Undoubtedly, other factors have also contributed to the securitization trend.

We believe it is too early to determine the extent to which the securitization process will develop. In assessing growth prospects, however, it is necessary to clarify the concept of securitization. Commercial paper, for example, represents short-term debt that is generally sold by large corporations to institutional investors and other corporations. It is not, however, securitized in the sense that the issues are pooled and distributed to investors.

Commercial paper has a long history in this country. In modern times, however, it is evident that the dollar volume of commercial paper outstanding expanded at a significant and steady pace from the early 1960's to the mid-1970's. Since then, the growth in the amount outstanding has accelerated. The Federal Reserve Bank of Richmond* explains the upswing as follows:

> "The recent rapid growth in the commercial paper market owes much to the secular substitution of short-term for long-term debt, which accelerated because of the high inflation in the late 1970's. Volatile interest rates due to uncertainty about the future rate of inflation makes firms hesitant to structure their balance sheets with long-term fixed-rate assets and liabilities. In addition, because of inflation's debilitating effects on equity markets, debt has grown more than twice as fast as equity during the past decade..."

*Peter A. Abken, "Commercial Paper," Instruments Of The Money Market, The Federal Reserve Bank of Richmond (1981), p.103.

The mirror image of the sharp growth in commercial paper during the late 1970's and early 1980's is the sluggishness in the volume of bond issues offered. In the years 1979-1982, for example, net new bond issues averaged about $30.0 billion per year, down from $41 billion in 1976. Last year, a period in which interest rates and inflation were at much lower levels, the volume rebounded to $60 billion. These trends tend to confirm the observation of the Federal Reserve Bank of Richmond that the growth in the commercial paper market reflected, to some extent, an alternative to the issuance of long-term debt by business enterprises.

It should be emphasized that, while the dollar value of commercial paper outstanding has expanded dramatically since the mid-1970's, commercial loans of banks have likewise increased. Between December 31, 1975 and March 31, 1985, commercial loans rose from $176 billion to $480.4 billion. Over this same period, total bank loans also expanded from $496.9 billion to $1.4 trillion. Finally, available data show that commercial banks have maintained their share in the total credit market, notwithstanding the growth of the commercial paper market and other developments. As the Federal Reserve Bank of Minneapolis

pointed out in a report which we have previously brought to the attention of the Committee:*

> "...banks have maintained their share of total intermediation over the last three decades and in some important submarkets has actually gained market share.
>
> "Other evidence suggests that banks' share of total intermediation would be even larger if the analysis were carried on beyond domestic boundaries."

If the trend toward securitization continues, there is clearly a need to look carefully at the degree of investor protection provided under the existing regulatory framework. As the recent experience of a large west coast bank illustrates, customers who purchase securitized loans may be confused as to whether they are buying paper issued by the bank or its holding company or if they are purchasing an insured deposit. Moreover, there has been a lack of regulatory sensitivity in bank regulatory agencies as to the methods and procedures used to assemble interests in these portfolios.

Finally, should the banking industry continue on the road of securitization, the possibility exists that many banks will cease being banks in the traditional sense and become intermediaries who transfer both the credit and interest rate

*Proposed Bank Entry Into Mutual Funds: Some Economic Policy Issues, Investment Company Institute, p.4.

risk in the loans they originate to the investing public. Should this occur, it could represent a loss to the economic well-being of the country. The ability and necessity for banks to assess risk carefully, customize lending arrangements and maintain a continuing relationship with borrowers have been essential ingredients in the success and vitality of our free enterprise economy. To the extent that banks become primarily packagers and vendors of standardized loans, it would represent an economic loss in these areas.

2. Q. Are "junk" or high yield bonds part of this trend - a security instrument which is a close substitute for bank loans in the middle market?

A. High-yield bonds, like commercial paper, are not part of the trend toward securitization, as we understand that term. There have always been many high yield or "junk" bond issues in the marketplace. Traditionally, these have been original issue obligations of smaller companies without prime ratings or the outstanding obligations of large companies which were once in a highly rated category but which have fallen on difficult times. The recent increase in the issuance of junk bonds has more to do with corporate takeovers and leveraged buyouts than with either corporate loans or the traditional bond market.

In 1984, for example, the Federal Reserve Board indicated that bonds with a rating of Ba1 or below totalled around $16.1

billion. Of that amount, almost $11 billion were merger-related. When the present period of takeover activity and its attendant publicity subside, it would not only be reasonable to assume that the junk bond phenomenon will also recede from view. However, these obligations will continue to fulfill their traditional role, appealing to investors who desire high returns and are willing to assume commensurate risk.

3. Q. If this trend toward "securitization" does continue, aren't many of banks better quality customers likely to end up with less and less of a need for a bank? If this proves to be the case - and banks are not given the right to evolve with the marketplace - won't banks become increasingly less profitable, less stable, and forced into higher risk loans?

A. While securities firms may underwrite and distribute participations in these portfolios, banks are at least full and necessary partners in the securitization process, as the primary originators and servicers of the securitized loans. As noted above, much existing securitization activity originates because depository institutions want to avoid carrying long-term loans on their books. However, the depository institutions remain the originators of this paper. The securitization phenomenon depends upon depository institutions to create new loans, and consequently does not herald the growth of a competing financial

business. Thus, from this standpoint, there is no reason to think that depository institutions will be displaced as the primary originators of and servicers of securitized loans, at any time in the foreseeable future.

As to the last part of the question, we do not believe that banking has become less profitable because banks have been generally restricted to the banking business. William F. Ford, President of the Federal Reserve Bank of Atlanta* emphasized in a 1982 article that commercial banks have not only been profitable but they have enjoyed prosperity for a long time.

> "...the banking industry has achieved a remarkable string of annual improvements in earnings. It has now been 20 years since the industry as a whole has experienced a decline in net income after taxes. In fact, during the last 20 years the industry's earnings have increased more than sevenfold. Moreover, in the seventies, the net income of all banks rose from under $5 billion to over $14 billion -- almost tripling during a period when prices rose dramatically, but at a slower rate than bank earnings. In other words, bankers have succeeded in keeping their earnings growing at a rate that has outpaced inflation during the past two decades..."

In recent years, bank profitability has slipped. The major factors contributing to this trend are an increase in loan-loss provisions and the lingering effects of interest rates that, while declining, have remained high by historical standards. Sharply declining interest rates in the marketplace over the past

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*William F. Ford, "Banking's New Competition: Myths and Realties," Economic Review, Federal Reserve Bank of Atlanta (January 1982), page 5.

twelve months, combined with the fact that administered bank loan rates are falling much more slowly, should provide a strong boost to bank profits in 1985.

Thus, despite much talk to the contrary, no convincing data have been presented which suggest that banks will become increasingly less profitable. Interest rate deregulation may have deprived poorly managed banks of automatic profitability, but no business in this country enjoys, or should enjoy, a right to be profitable if it is poorly managed.* If the large banks seriously believed that there are substantially better returns to be earned by deploying their assets outside of banking, they would cease to be banks and go into more lucrative financial businesses. We have observed no such trend.

4. Q. Is financial planning and full service implementation of financial plans for both individuals and businesses a major trend in the financial service industry?

A. Yes. The growth of financial planning has been a major development in the marketplace for financial services. In the past, this market has been served mainly by securities brokers, insurance agents, investment advisers, lawyers and accountants.

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* Colloquy between Senator Garn and John B. Carter (Representative for ACLI) regarding causes of bank failures; page 91-92 of unofficial transcript of Senate Banking Committee hearings on June 19, 1985.

Today, however, the Securities and Exchange Commission is currently registering new investment advisers at an estimated rate of 200 per month, many of whom are financial planners.

Because of the varied backgrounds of persons who have entered the financial planning field, as well as for other reasons, many financial planners do not sell a full range of the financial products they may recommend to their clients. Indeed, some eschew the sale of any product and charge a planning fee to avoid any possible conflict of interest. Thus, the extent to which there has been "full service implementation" of financial plans by planners cannot be quantified nor does it seem that such a service is a necessary ingredient in the business.

As to banks, their traditional role in financial planning has been implemented in an individualized fiduciary context through their trust departments, which had assets of $763 billion at the end of 1983. As for "full service implementation" by banks acting in this context, the Supreme Court pointed out in Investment Company Institute v. Camp, (401 U.S. 617(1971)), that if banks could sell their own mutual funds to the public, there is the danger that they would compromise their traditional fiduciary role as a provider of disinterested investment advice.

If for other reasons, it is determined that banks will be permitted to mass-merchandise financial planning services outside of their traditional trust role, there is good reason to reexamine the present bank exemption from registration as investment advisers under the Investment Advisers Act of 1940.

This is yet another piece of the larger picture which calls for an overall reexamination of the existing financial services regulatory structure.

5. Q. Are you in favor of complete divestiture of nonbank banks? Why or why not? Are you further in favor of redrawing lines between the financial segments? If so what bank-like products should securities firms be required to divest? In what areas should competition be permitted to continue?

A. As we have pointed out in our testimony last month and in a letter to the Committee last year, the termination of nonbank banks coupled with legislation permitting broad bank entry into the securities business would be inequitable in the extreme.* We believe that the Congress is faced with a policy decision which either requires movement in the direction of a full integration of financial services, i.e., free and open competition in every aspect of the financial services business, or the restoration of the traditional Glass-Steagall demarcation between the banking business and the securities business. Shutting the doors on the nonbank bank foothold in banking while broadly "deregulating" banks so they can engage in a wide variety

*Letter to the Members of the Senate Committee on Banking, Housing and Urban Affairs, April 24, 1984.

of securities activities seems to be a radical cure appropriate only if the securities industry were driving the banking industry to the verge of extinction. Such is not the case.

Because it is necessary to reach a consensus on much larger issues, i.e., broad deregulation versus enforcing the Glass-Steagall line, it is difficult to detail what kind of bank-like products securities firms should be required to divest. Clearly however, any restructuring should subject securities products of banks to securities regulation. An obvious example of such a security activity, about which we have repeatedly testified*, is the management of collective funds in bank trust departments. These funds, which totaled $155 billion at the end of 1983, have developed far beyond what was considered appropriate and relevant in 1933.

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*Hearings on Competitive Equity in the Financial Services Industry before Senate Banking, Housing & Urban Affairs Committee, 98th Congress, 2nd Session, Pt. III at 670. (1984).

Oversight Hearings before Senate Committee on Banking, Housing & Urban Affairs Committee, 98th Congress, 1st Session, Pt. II at 776 (1983).

Hearings on Securities Activities of Depository Institutions before Subcommittee on Securities of the Senate Banking, Housing & Urban Affairs Committee, 97th Congress, 2nd Session, at 255 (1982).

Hearings on Financial Institutions Restructuring and Services Act of 1981 before the Senate Banking Housing & Urban Affairs Committee, 97th Congress, 1st Session, Pt. I, at 633 (1981).

At a minimum, bank collective funds should be managed outside the bank and should be under the regulatory scheme of the Investment Company Act of 1940 and other applicable securities laws.

In certain areas, possible competitive imbalances have already been addressed by legislation. For example, the development of money market funds led to the effective repeal of interest rate ceilings through the creation of money market deposit accounts (MMDAs) for banks. At present, assets of money market mutual funds total approximately $212 billion, while the bank MMDAs have assets of over $460 billion. (In December 1982, just prior to the effective date of the Garn-St Germain Depository Institutions Act of 19[illegible] which created money market deposit accounts, money market mutual funds reached their all-time high of $232 billion.)

While some in the banking industry continue to raise the money market fund "issue" as justification for further expansion into the securities business, this is merely an exercise of waving the bloody shirt. There are persons in the mutual fund industry who argue that MMDAs have an unfair advantage over money market funds in that depository institutions are free to set arbitrary rates of return on these federally insured accounts. Whatever merit there may be in the positions of either side, the marketplace, after Garn-St Germain, seems to have reached an equilibrium, albeit with some slight advantage being reflected in the preponderance of dollars in the deposit accounts as compared

to the funds. Thus, it would seem logical to permit competition to continue in this area, particularly where the consumer benefit is so clear.

6. Q. (a) Isn't an S&L with a large percentage of its assets in high yield bonds an insured mutual funds?

A. (a) No. A mutual fund is an investment vehicle; an S&L is not. Shareholders of a mutual fund are investors; people who deposit money in an S&L are savers, not investors.

The essence of a mutual fund is that the investment experience of the fund -- gains or losses -- is required by law to be passed through to the shareholders who invest in the mutual fund. If a mutual fund holds high-yield bonds which return, for example, 14 percent, that is what shareholders in the fund receive (less fund expenses which might be around 1 percent). If interest rates change or a bond defaults, the shareholder's share value immediately changes to reflect such developments. Whatever the nature of the underlying investments, a mutual fund investor is an equity shareholder who, on a pro-rata basis, shares in the success or failure of the fund's investments.

On the other hand, an S&L holding high-yield bonds is under no requirement to pay its portfolio earnings to its depositors. The depositors are not investors in equity securities; nor do they share in the investment experience of the S&L's portfolio.

Thus, in the above example, despite a 14 percent return on its bond portfolio, an S&L would in all likelihood pay its depositors, who own MMDAs, the local prevailing interest rate, currently 8 percent, and keep the difference. Unlike a mutual fund, however, the S&L's depositors are not at risk; their returns are stipulated and their deposits are federally insured. Neither interest rate fluctuations nor defaults affecting the value of the S&L portfolio will alter the depositors rate of return, unless, of course, the return on the portfolio falls below the return promised depositors. In such a case, the S&L may become insolvent, but the depositors would receive FSLIC protection. Mutual fund shareholders do not receive any such protection.

Q. (b) Should a well capitalized S&L be prohibited from investing in a diversified portfolio of high-yield bonds because it would have a competitive advantage over other mutual funds?

A. (b) As implied in the answer to part (a), S&Ls should not be prohibited from investing in high-yield bonds because they would have any competitive advantage over mutual funds. As discussed above, the composition of an S&L's portfolio would not make it the functional equivalent of a mutual fund. S&Ls and mutual funds remain very different organizations -- S&L depositors are savers insulated from loss, not investors who bear market risk. In the unlikely event that an S&L somehow converted

into a mutual fund, passing substantially all of the gains from its bond portfolio to its depositors, while insulating depositors from any risk because of its FSLIC insurance, then, indeed, such an S&L/mutual fund would have an enormous competitive advantage over other mutual funds. However, such a development would most certainly be prohibited, not because of the unfairness to ordinary mutual funds, but because the FSLIC and the Treasury of the United States would then be insuring investors, not depositors.

7. Q. In his testimony, Mr. Linton of Drexell Burnham indicated that his company's nonbank bank serves as a convenience to the company's IRA and mutual fund customers. In the interest of fairness, should banks be given mutual authority only for IRA and Keogh's?

A. We welcome the opportunity to clarify the semantic confusion which crept into the colloquy involving Mr. Linton's testimony. Drexel Burnham's nonbank bank acts as a custodian for IRAs* and does not offer any investment vehicle (including deposits) or money management services to IRA. It is purely

*We do not discuss Keogh plans separately as the points applying to IRAs are equally apposite to these plans. Moreover, the requirements applicable to Keogh plans, including the trust or custodial requirements applicable to such plans, are now essentially the same as those applicable to corporate plans as a result of the "parity" provisions of the Tax Equity and Fiscal Responsibility Act enacted in 1982.

being used as a custodian of IRA accounts which may consist of mutual funds, among other investments. The custodial activity performed by that institution is a function that may be lawfully performed by many financial institutions, but which today, under current IRS regulations is overwhelmingly dominated by the traditional banking industry to the virtual exclusion of any other financial service provider.

There are two relevant business aspects of an IRA -- the investment vehicle itself (selected by the IRA participant) and the custodianship of the account (as required by law.) On the investment side, banks and S&Ls have been the most successful vendors of IRA investments. Over 60 percent of all IRA investments are in depository instruments. Approximately 13.3 percent of IRA investments are in mutual funds.

The following chart illustrates the distribution of IRA assets by type of major financial institution at the end of March 1985.

INSTITUTION	PERCENTAGE
Commercial Banks	26.0
Mutual Savings Banks	6.3
Savings and Loan Associations	23.5
Life Insurance Companies	10.5
Credit Unions	6.3
Mutual Funds	13.3
Direct Investment in Stocks and Bonds	14.1

On the custodial side, where there are no published figures, it is our understanding that traditional commercial banks probably act as custodians for more than 90 percent of all IRA assets. The Employee Retirement Income Security Act (ERISA), which created the IRA accounts, requires, through a provision of the Internal Revenue Code, that all IRA accounts must be held in the custodianship of a bank or some other financial institution, regardless of the investment vehicle chosen by an IRA investor. This is to assure the IRS that taxpayers are not mingling these tax preferred investments with their other assets. Since few other financial institutions have been able to qualify as custodians under IRS rules, almost all of the $175 billion in IRA accounts is held in custodial accounts by traditional banks, whether the underlying investment is in a depository instrument, a mutual fund or in other securities.

Thus, while the depository sector is the dominant investment medium for IRAs (even without having securities products to offer) on the custodial side, it is virtually a shut-out in favor of the banking industry.* There is no competitive imbalance against banks as implied in the question since no participating financial institution is being treated unfairly -- except perhaps securities firms by the IRS.

* The securities industry has long believed that the IRS should be more liberal in permitting other financial institutions to be custodians since ERISA permits such arrangements. But that, of course, is another matter.

8. Q. I note that mutual fund assets seem to be invested to a great extent in commercial paper. What percentage of mutual fund assets are so invested? How were these commercial paper issuers financed, say, 10 years ago?

A. Mutual funds have always held commercial paper. Equity, bond and income oriented mutual funds, for example, often hold some commercial paper in the "cash" portion of their portfolios. As of May 1985 these funds held a total of $6.1 billion in commercial paper or only 3.4 percent of their total net assets. In recent years, however, money market funds have also included commercial paper in their portfolios. Of the $212.6 billion of assets of these funds, $92 billion, or 43.2 percent, was invested in commercial paper in May 1985. It should also be noted that money market funds finance loan and investment activities of commercial banks, as well as those of businesses, consumers, and governments. At the end of May 1985, for example, money market funds held $16.0 billion of bank certificates of deposits and $16.4 billion of bankers acceptances in their portfolios.

Mutual funds provide financing to businesses through their purchase of commercial paper and other securities. Banks provide financing to businesses through the extension of commercial loans. These forms of financing also compete with the issuance of long-term corporate debt traditionally underwritten by

securities firms. Similarly, since the post World War II period, the increased long-term lending by banks competes with the issuance of bonds by securities underwriters.

Today, business borrowers seeking to satisfy their specific financial needs can choose among banks, securities underwriters, insurance companies or venture capital firms. It is this diversification in available financial options which has been a hallmark of the vitality of the American capital markets. Such diversification is the essence of competition, even though, over time, there is an ebb and flow in the competitive fortunes of the various credit providers as market conditions change. It would be a retrogressive step to enact legislation concentrating all of the existing credit providers in giant financial conglomerates. Not only would competition diminish, but decision-making would tend to become homogenized and centralized. The impact would be particularly felt by small businesses whose range of financing options would be diminished.

9. Q. Do you believe that one third of the American population - which you say has expressed an interest in integration of financial services - is an insignificant percentage of the population? In 1976 what was the consumer interest in money market funds? In 1982? Do you think that the one third may increase in size over the next five years?

A. One-third of the American population is, of course, not insignificant. The point made by our testimony on consumer preferences is that the movement for expansion of bank powers is not consumer-driven. In particular, the push for mutual fund authority is not even bank driven in that it is only the nation's largest banks which would use this power. A 1983 study prepared for the American Bankers Association pointed out that:

> "For the small community bank [mutual] fund management is not cost effective. A community bank cannot generate the critical mass, the break-even volume that is required to profitably manage funds."*

The same study reported that banks which are interested in creating mutual funds tended to be larger and anticipated offering mutual funds through correspondents or other banks in a multi-bank holding company[whereas]...

> "small banks saw much less potential in mutual funds...and indicated that they did not have the market for mutual funds nor the expertise to manage funds."

This view was also confirmed at the recent hearings by the President of the Independent Bankers Association who stated that "the limited securities powers [contained in S. 2851] will not be

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* Assessment of Business Expansion Opportunities for Banking, March 1983, at 243.

used by the vast majority of community banks."* Finally, according to the American Banker, the 1983 FDIC proposal to permit 9000 smaller banks to enter the mutual fund business "has barely created a ripple of interest among banks that could engage in such activity.**

We think the most impressive point of the consumer surveys, none of which to our knowledge was sponsored by any securities-related organization, is that those respondents expressing concern about increased concentration of bank powers and a preference for individual service providers outnumbered those that expressed a desire to obtain financial services from integrated providers.

However, despite consumer preferences in this matter, we would expect that if banks are given mutual fund authority, most of the mutual fund industry would be acquired by a relatively small number of large banks. As we pointed out in our submission to the Committee last year, the financial resources of the nation's large banks so dwarf the capitalization of even

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*Testimony of B. F. (Chip) Backlund, June 19, 1985 at 11.

** FDIC Proposal for Bank Securities Underwriting Attacked by Legislators, American Banker, May 26, 1983.

large mutual fund organizations as to make amalgamation inevitable.* Moreover, no provision of current law nor any provision contained in S. 2851 would prevent this from occurring. The end result is that the public would be "told" that the age of integrated financial services had arrived, regardless of what preferences consumers might have.

The remainder of the question asks about consumer interest in money market mutual funds in 1976. We have no direct surveys as to money market fund popularity in that year. Their asset size at that time was $3.7 billion. In 1982, with interest rates reaching new peaks, money market mutual funds reached a peak level of $232.0 billion. A good part of this growth, of course, was tied to the existence of Regulation Q and, as pointed out in the answer to question 5 above, the size of money market mutual funds has actually decreased over the last two years.

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* Hearings on Competitive Equity in the Financial Services Industry before the Senate Committee on Banking, Housing and Urban Affairs, 98th Cong., 2nd Sess., Pt III at 697 (1984).

10. Q. If banks are allowed to enter the securities business, how would you recommend creating a stronger, better integrated regulatory system to replace the prohibitionist approach of Glass-Steagall?

A. We believe that a decision to permit banks to enter the securities business should likewise permit the broad-scale entry of all securities firms into banking. We have also, on many previous occasions, pointed out that substantial strengthening of the existing regulatory structure will be necessary. In this regard, we have made specific and comprehensive legislative suggestions in our testimony during the hearings on S. 2181 and S. 2134 in March, 1984. These proposals were designed to deal specifically with conflicts of interest and competitive equity. We continue to believe that these proposals provide a sound point of departure for the development of an appropriate regulatory framework--assuming a policy decision is reached to modify the Glass-Steagall Act.

In addition to fashioning specific controls, significant problems of regulatory coordination will be created by the integration of bank securities firms and other financial service providers. The current regulatory authority of the various government agencies is essentially co-extensive with the traditional product lines offered by existing non-integrated

financial firms. Integration of these firms will, moreover, spur the creation of hybrid products and will create regulatory gaps and confusion, as agencies with obsolete jurisdictional boundaries attempt to perform their supervisory functions. Finally, uneven regulatory performance will also create new competitive inequities between integrated firms primarily regulated by different agencies. Some integration of regulatory agencies or mandated coordination of examinations and regulatory activity will be imperative to prevent these problems.

Even today, as banks, securities firms and insurance companies have developed new products, the existing agencies, which were designed to regulate traditional product lines, have been subjected to increasing strain. This becomes particularly apparent as these agencies stretch to regulate new activities. For example, the efforts of the Comptroller of the Currency and the FDIC to "regulate" securities activities of banks have been inadequate, while the Securities and Exchange Commission has had difficulties coping with products which have been held to be securities but which also fall within the jurisdiction of state insurance agencies. Conversely, it has all too often become apparent, after the fact, that no regulator has effective jurisdiction in a particular area and that abusive practices flourished in these regulatory gaps.

While functional regulation would bring a degree of order into the present disarray, it is not a panacea. Some problems would be solved, but many of the major problems which would be presented by bank entry into the securities business would remain and new ones would be created. Where a problem is solely jurisdictional, the functional approach works best. Clarifying the authority of the SEC to regulate bank-affiliated broker-dealers is one such instance, since the SEC is the expert regulator of broker-dealer activities.

Other examples in which functional regulation will be inadequate have already been mentioned in answer to previous questions. As we have stated, removal of the bank exemption from investment adviser regulation would achieve functional regulation in the financial planning area, since banks which seek to mass-merchandise these services will then be subject to the appropriate regulatory authority. However, many financial planners, including their trade associations, believe that the present regulatory framework is inadequate to deal with this rapidly developing area. Functional regulation in this case solves but one aspect of the problems presented by this rapidly expanding field.

Another example is securitization. Clearly, the packaging and public offering of securities interests in a pool of assets

calls for SEC regulation. Conceptually, this type of pooled product falls well within the traditional jurisdiction of the SEC. Yet, at this time there is confusion as to which of the federal securities laws apply to this growing activity. Thus, functional regulation is a beginning, not an end.

Another type of problem not simply cured by functional regulation is presented by bank common and collective trust funds. As an outgrowth of their trust powers, banks, since 1933, have developed new forms of common and collective funds which now amount to $155 billion. These funds are subject to the Comptroller's Regulation 9 and are not subject to the federal securities laws. Since S. 2181, as introduced, would not have transferred these funds to SEC regulation, banks would have been able to develop a full range of mutual funds to complement their common and collective funds, while mutual fund managers could not do likewise. Moreover, banks' total securities investment operations would have been subjected to fragmented regulation.

Yet another problem area arises from the necessity to fashion regulations to deal with the special hazards that Glass-Steagall was designed to prevent.

As we have pointed out in our testimony, the present securities laws were written with the belief that the Glass-Steagall Act effectively removed banks from the securities business. While these laws contain many specific provisions dealing with potential conflicts of interest and other problems

of broker-dealers and investment advisers, they do not deal with the special problems of bank-related securities activities. Merely subjecting banks or their securities affiliates to the existing securities laws will not solve the many complex problems of bank reentry into the securities business.*

We must say, however, in all candor, that functional regulation, even buttressed by the specific regulatory proposals we have advanced, may prove to be only part of the answer. As stated above, there are both logical inconsistencies and practical problems in the legislative integration of financial service providers, while leaving the various regulatory agencies free to go their own way, myopically regulating along their traditional product lines. Serious thought must be given as to whether integrated financial service providers should continue to be regulated by separate regulators or whether these agencies should be reorganized or merged.

If it seems desirable to retain separate regulatory entities to regulate integrated providers, some form of inter-agency council should be formally created and chartered with a mandate to coordinate examination and regulatory policies for the effective protection of the public. Such a group could also ensure that overlapping regulatory policies were coordinated,

* Written testimony of David Silver before the Senate Committee on Banking, Housing and Urban Affairs on June 20, 1985, pps 12-13.

make certain that no regulatory gaps develop through product variation, and maintain an equitable field of competition.

Our basic point is that some method must be found to integrate and harmonize regulatory policies. Much energy has been expended on struggling with the competitive issues raised by financial integration, but far too little legislative attention has been devoted to the grave regulatory issues such a step would precipitate. As we have said repeatedly, our industry remains ready to play a constructive role in any broad endeavor to solve these admittedly difficult and complex issues.

* * * * * * * * * * *

Based on a series of developments regarding the internationalization of the securities markets, Senator Proxmire has asked the following two questions:

1. To what extent do you think the private sector should be involved in the study of these issues and any recommendations that might be made to Congress on this subject?

2. What are your views on the importance, relevance, and timeliness of addressing this subject now?

We believe that the issues dealing with the internationalization of the securities markets which were highlighted in Senator Proxmire's recent communication to the SEC

are extremely important and timely. They warrant Congressional consideration and we believe that the private sector should be involved in any study of these issues. While the time may not have come for substantive legislation, Congressional involvement by way of oversight hearings or a study would be appropriate. Internationalization involve issues of investor protection, the integrity of the American securities markets and trade reciprocity.

The Institute has become increasingly aware over the past few years of the significance of the issues referred by Senator Proxmire to the SEC for consideration. Mutual funds and their 20 million shareholders are affected by the developments in the world securities markets. In the recognition of the increasing internationalization of the securities markets, the Institute has recently written to the SEC urging consideration of some of the unique problems facing mutual funds. Thus, for example, the use of foreign custodians for mutual fund assets raises issues under the Investment Company Act; the existence of world-wide trading in securities outside the normal trading hours of the New York Stock Exchange raises issues concerning the pricing of mutual fund shares; and the purchase of the securities of certain types of foreign issuers, may raise other questions under the Investment Company Act.

In addition, we note that the SEC has responded to the efforts of foreign mutual funds to sell their shares in the U.S. by requesting legislation easing present restrictions on such funds. Unfortunately, this proposal is much too narrow, because it would do nothing to ease the substantial entry barriers faced by American mutual funds seeking to offer their securities in foreign markets.

We think a better approach to multinational offerings of investment company securities is to seek bi-lateral or multi-lateral agreements setting forth acceptable regulatory standards and providing for true reciprocity. The European Economic Community (EEC) is developing a directive on investment companies that aims at permitting sales of shares of European investment companies in all member countries. The Institute is currently exploring whether the European directive could form the basis for an agreement between the U.S. and the EEC which would ultimately permit sale of American funds in Europe and European funds in the United States. We believe that our government should take an active interest in this initiative and start laying the groundwork for an agreement between the European community and the United States permitting international offerings of investment companies on a reciprocal basis. We have expressed these views to both the SEC and the Department of Commerce, and we have sought the assistance of the Department of Commerce in monitoring the progress of the European initiative.

Investment Company Institute
1775 K STREET N. W., WASHINGTON, D. C. 20006
(202) 293-7700

DAVID SILVER
PRESIDENT

April 24, 1984

The Honorable Jake Garn
Committee on Banking, Housing and Urban
Affairs
SD-534 Dirksen
Washington, DC 20510

Dear Mr. Chairman:

We would like to thank you and all of the members of the Banking Committee for the opportunity to testify on S. 2181, the Financial Services Competitive Equity Act and S. 2134, the Depository Institutions Holding Company Amendments. We think that apparent developments since the hearings call for some further comment. We are particularly concerned about the possible emergence of a Janus-faced bill which, on the one hand, would close off access to banking by other businesses while, on the other, would grant banks broad new securities powers.

You may recall that the thrust of the Institute's testimony before the Committee was two-fold in its approach: regulatory and competitive.

The framework within which we considered these two issues included a recognition that the banking industry is unique because it is sheltered, protected and subsidized by law and historic public policy. We did not quarrel with the various public policy considerations which are responsible for the special economic and legal status which banks enjoy. However, we did express the view that the history of bank excursions into securities and securities-like activities, such as REITs, demonstrated that existing bills were seriously defective in coping with the regulatory problems posed by bank entry into the securities business. While some observers question whether the inherent problems that occur when the banking and securities business combine can be resolved by anything but complete separation, we suggested that amendments could be fashioned to ameliorate these regulatory problems.

On the other hand, with respect to competitive considerations, we expressed deep concerns that the issue of expanded bank powers, including mutual fund powers, presented the Committee with a very serious policy dilemma: how to preserve a fair field of competition between banks, which enjoy unique legal and economic protection, and those businesses which enjoy no such special status, but with which banks would be free to compete.

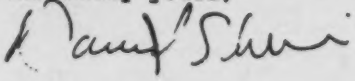
We understand that the scope of any bill which might emerge from the Committee's deliberations is likely to be different from S. 2181. Lately, the debate has focused on a "core" bill, the major aspects of which would do several things: close purported loopholes that have permitted firms which are engaged in other businesses to enter some aspects of the banking business, thus bank competitors would be excluded from banking; address the proliferation of state-chartered bank powers, thus, the integrity of a national banking system would be protected; streamline the Bank Holding Company Act; and possibly contain provisions which would cut back supposed advantages that thrifts currently hold over banks. We also understand that expanded bank powers is sometimes considered as part of this "core" bill.

Any "core" bill that would permit banks to engage in the mutual fund business and perform other securities activities which at the same time preserves and enhances the protected status of banks, would dispose of the policy dilemma in a fashion which is both blatantly discriminatory and anti-competitive. The "loophole" closing, "streamlining," and "thrift redefinition" provisions all act to restore the banking industry's monopoly over banking while at the same time the "expanded powers" provisions act to give banks a large part of other businesses which are now independent of banking. A "core" bill that would both protect the banking system from competition and grant new, controversial powers to already economically powerful banks will inflict severe damage on and weaken other sectors of the American financial industry. The major competitive advantages which would accrue to the banking industry under such legislation would soon be translated into dramatically increased concentration of economic power in the nation's largest banks.

The issue of expanded bank powers cannot be settled as part of a "core" bill. Expanded powers for banks must be considered in a larger context -- in a context that thoroughly examines the effects on the mutual fund industry and on the securities business as a whole. This is particularly important if banks are permitted to bring their unique competitive advantages to bear in the marketplace.

To date, there are no convincing arguments -- neither economic necessity, consumer benefit, nor any other public policy consideration -- which would lead to the granting of mutual fund powers to banks in the context of a bill which does not provide for opening the doors to permit competition in banking. We respectfully hope that you will agree.

Sincerely yours,



The CHAIRMAN. I apologize to you. I didn't realize it was going on. David, I would say to you, I much more enjoyed talking about photography with you than I did about this subject. So come on in and we'll talk about cameras and we'll ignore all of this stuff.

Mr. SHAPIRO. Sometime, will you share something about space with us?

The CHAIRMAN. Oh, I'd love to. I'll be an absolute bore the rest of my life on space.

Mr. SHAPIRO. We'll take you up on that.

The CHAIRMAN. Go see the new movie at the Air and Space Museum. It's the closest you'll ever get to being in space. It's with the new IMAX camera. I saw it last night. It deals with the g's and the zero g's. It is spectacular. They took movies with this large format IMAX camera on three shuttle missions last year. It starts on Friday, tomorrow. I intend to see it once a week.

Mr. SHAPIRO. Is the launch the most exhilarating part of the experience?

The CHAIRMAN. Well, if you force me to one, yes. But, there are a lot of close seconds. The reentry of the 9,000-mile descent from west of Australia to the 3-mile runway is rather exciting, too.

The committee is adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Additional material supplied for the record follows:]

51-337 O—85——41

STATEMENT OF JOHN P. KELLY, JR.

EXECUTIVE DIRECTOR OF THE

NATIONAL BANKERS ASSOCIATION

Mr. Chairman and Members of the Committee:

I am John P. Kelly, Jr., Executive Director of the National Bankers Association. The National Bankers Association (NBA) is the 58 year old trade association of the nation's 104 minority banks. The Association represents minority banks located in over 60 urban areas, in some 30 of these United States and territories. The Association and its members, thank you for the opportunity to present its views and concerns regarding financial institution legislation.

We are aware of the comprehensive philosophical and theoretical positions presented to this committee on the various areas of potential bank legislation. Therefore, our comments will be limited to one area of primary concern to the minority banking industry and a brief statement of our position on certain key aspects of banking legislation.

Structure

Of the many structural issues, the NBA is most concerned about the preservation of minority banks and the banking services they provide to their communities. The Association maintains that there is a link between a "failing institutions provision" and "basic or lifeline" banking.

This link is forged when a minority banks is created. Since the principal reason for the formation of most minority banks has been to provide banking services, that were otherwise unavailable or denied to a particular community with those community being typically urban, minority and at the lower end of the economic ladder - minority banks have been servicing the people and communities most often described as being in need of basic banking services. They have been and are the minority bank's market, their "bread and butter".

Over the years, minority banks have learned how to successfully service these communities, while operating a sound and profitable bank. Today some call this basic or lifeline banking, but for most minority banks this is simply "business as usual". So called basic or lifeline banking has been the staple business for minority banks since 1888, when the first minority financial institution, the Savings Bank of Grand Fountain, United Order, True Reformers was founded.

Since that time, minority financial institutions have continued to serve as the providers of financial services to their local communities.

In a rapidly changing and deregulated environment, this task becomes increasingly difficult. This is made quite evident when we lose a minority institutions due to regulatory closure, acquisition or merger. Since October 1981, approximately twenty (20) minority banks have either failed, been acquired or merged into larger majority institutions (see attached listing). The impact has been a loss of services to the communities they once served. These banking services will not be replaced or if replaced are not rendered to the extent or in the manner that a successful minority bank would have serviced that community.

The minority banking industry now has the human and financial resources to assist any minority bank in need of capital or management talent.

The problem has been that the failing bank is not always located in the same geographic area as the available human and financial resources. When it is, as in the recent case of of the Douglass State Bank, Kansas City, Kansas, minorities are afforded an opportunity to assist in retaining the minority character of the troubled institution.

Present banking legislation and regulations do not allow the regulatory authorities to seek non-local minorities, when they have a failing minority bank on their hands.

The solution that our Association would put forth, for your consideration, is the enactment of a Pubiic Law provision, that would create for commercial banks a provision, similar to Section 123 (C) of Public Law 97-320 "The Garn - St. Germain Depository Institutions Act of 1982". This section provides that "... In the case of a minority - controlled institution (S&L), the Corporation shall seek an offer from other minority - controlled institutions before proceeding with the sequence set forth in the preceding subparagraph..." The preceding subparagraph establishes the procedure for the the merger, acquisition of a failing S&L.

I am sure that the members of this Committee are aware of the fact that, the Senate's version of this legislation, at one point, did include minority commercial banks.

Discussions have been held with the FDIC, the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency on this subject. They have not expressed opposition and in fact have been supportive of our efforts and offer of assistance in this area. I have attached correspondence from the FDIC and the Federal Home Loan Bank Board, which indicates their support and efforts to preserve the minority character of failing minority institutions. In conversations with the Office of the Comptroller of the Currency on this subject, as a way to resolve the problem they have suggested we form a bankers' bank, which is presently under study by the Association.

Passage of this type of provision would serve to insure that minority banks and their unique role in our economic fabric are preserved and banking services are retained and provided to all segments of the community desirous of such services.

A provision of the type described above would enable a greater number of minority institutions to survive the changes that our industry will continue to experience, in the coming years.

OTHER BANKING ISSUES

While a provision that would allow minorities an opportunity to bid on a bank that is failing, regardless of geographic location, is our primary concern; we would like to take this opportunity to share with the committee our views on some of the other matters before the committee.

New Service Opportunities

The Association is in favor of legislation that would expand the permissible activities of banks to include the underwriting of municipal revenue bonds, mortgage-backed securities and commercial paper; the sponsorship and sale of mutual funds; real estate investment, development and brokerage; insurance underwriting and brokerage. The inclusion of the services noted above as permissible activities will increase competition in these areas, which will benefit local governments, individual consumers and businesses.

In connection with expanded powers, the Association is in favor of the simplification of the procedures to form a holding company and would support the reintroduction of S.2181 in the 99th Congress.

Regulation

On the subject of capital adequacy requirements the NBA supports a uniform standard for minimum capital ratios for all types of insured banks.

These minimum capital ratios should be issued and enforced as guidelines rather than regulations. The regulatory agencies should provide and specify an adequate period of time for banks to bring their capital levels up to those required without artificial or arbitrary constraints on bank growth or dividend policy.

Lastly, the definition of primary capital should be amended to include certain intangible assets that are widely recognized within the industry as serving purposes equivalent to those served by other types of primary capital.

The NBA is opposed to the payment of interest on demand deposits and certain NOW accounts, until and unless:

1. The commercial banks are granted expanded products and services, of the type described above.

2. Payment of interest on reserve balances held by the Federal Reserve.

Conclusion

Mr. Chairman, we thank you for the opportunity to present our views and concerns. We are prepared to assist you and the committee in your deliberations on these issues and any others that affect our industry and the communities they serve. Thank You.

LIST OF FAILED, OR ACQUIRED MINORITY BANKS SINCE OCTOBER 1, 1981

1. Bank of Finance, Los Angeles, CA
2. First Enterprise Bank, Oakland, CA
3. California Coastal Bank, San Diego, CA
4. First Women Bank of California, Los Angeles, CA
5. West Olympia Bank, Los Angeles, CA
6. Pacific Coast Bank, San Diego, CA
7. Golden Gate Bank, San Francisco, CA
8. Santa Ana State Bank, Santa Ana, CA
9. Hemisphere National Bank, Wash, D.C.
10. Manufacturers National Bank, Hialeah, FL
11. Popular Bank of FL, Hialeah, FL
12. Century National Bank, Jacksonville, FL
13. South Side Bank, Chicago, IL
14. Union National Bank, Chicago, IL
15. Tri-State Bank, Markham, IL
16. Pan American National Bank, Union City, NJ
17. Bank of Albuquerque, Albuquerque,N Mex
18. Plaza Del Sol National Bank, Albuquerque,N Mex
19. Plaza National Bank, Harlingen, TX
20. National Security Bank, Tyler, TX

NOTE: The source for this listing was the October 18, 1984 issue of the American Banker and the US Treasury listing of minority banks as of October 1, 1981. We have requested that Treasury provide us with a more complete and accurate list of minority banks that have failed or been acquired, if such data is available to them.

FDIC
Federal Deposit Insurance Corporation
Washington, DC 20429

Office of the Chairman

July 25, 1983

Honorable Fernand J. St Germain, Chairman
Committee on Banking, Finance and Urban Affairs
U. S. House of Representatives
Washington, D.C. 20515

Dear Congressman St Germain:

Your inquiry concerning the FDIC's handling of emergency acquisitions of minority-owned banks has been forwarded to me for reply. We assume you are referring to the FDIC's handling of assisted purchase and assumption transactions involving failing minority-owned banks.

The FDIC has been involved in a number of such transactions over the past several years. Enclosed are two memoranda covering the FDIC's guidelines and policies concerning the selection of potential acquirors of failing banks. You will note that we consider all candidates that meet our financial and managerial guidelines and are otherwise eligible to acquire the failing bank under existing statutes.

In meeting the "cost test" prescribed in Section 13 of the FDI Act, it is the responsibility of FDIC to attempt to obtain the largest possible premium and to see that the successor institution will be strong and viable. To this end, it is the practice of FDIC to assemble the largest possible list of potential bidders meeting our selection criteria. Being mindful of the unique nature of minority banks and their close association with the communities they serve, the FDIC, in failing bank situations, is conscious of the need to consider the preservation of this special relationship with the community served by the failing bank. To achieve this, we are careful to assure that all qualified minority institutions and minority groups who have expressed an interest in acquiring the failing institution are invited to bid.

Tangible evidence of our concern is manifested in previous actions by us to prevent the loss of banking services in minority communities. Most conspicuous of our actions was the financial assistance granted to Unity Bank and Trust Company, Boston (Roxbury), Massachusetts. In July 1971, Unity's severe financial problems resulted in the FDIC granting financial assistance pursuant to Section 13(c) of the FDI Act to assure continued banking services in the community of Roxbury. The assistance, notwithstanding, the bank was unable to attain viability after 11 years of operating under a conservator. However, after being closed by the Massachusetts Commissioner of Banks on July 30, 1982, the FDIC was able to facilitate a purchase and assumption with another minority institution which continued to operate the two offices of

Unity Bank. On three occasions, the FDIC established Deposit Insurance National Banks to continue to provide banking services to communities served by failed minority banks when we were otherwise unable to find a purchaser for the failed bank. Throughout our history only six such Deposit Insurance National Banks have been established. Only recently the FDIC for the first time in its history arranged for another bank, Seaway National Bank, a minority institution, to act as our agent to pay off insured deposits of another minority bank, Union National Bank of Chicago. We were unable to arrange for another institution to assume the liabilities of Union National. As a result of our actions, insured depositors of Union National can continue to bank at the same location. The FDIC thereby facilitated the continuance of banking services in the minority area served by the failed bank. We believe that an examination of the complete record will disclose extraordinary efforts by FDIC in this regard.

Inasmuch as it is the practice of FDIC to seek offers from qualified minority-owned banks in effecting a purchase and assumption transaction in failing bank situations, we see no benefit to be derived from amending the Federal Deposit Insurance Act to require FDIC to seek offers from minority-owned banks in such situations. We can envision no legislation that Congress could enact which would achieve more than that which is already being done by FDIC in considering the needs of minority communities in failing bank situations. We would not, however, be averse to legislation which permitted us to broaden the field of eligible acquirors of failing minority banks. One way in which this might be accomplished would be to permit FDIC to seek bids from out-of-state minority banks.

Sincerely,

Margaret L. Egginton

Margaret L. Egginton
Deputy to the Chairman

Federal Home Loan Bank Board

EDWIN J. GRAY
CHAIRMAN

1700 G Street, N.W.
Washington, D.C. 20552
Federal Home Loan Bank System
Federal Home Loan Mortgage Corporation
Federal Savings and Loan Insurance Corporation

AUG 2 1983

Honorable Fernand J. St Germain
Chairman
Committee on Banking, Finance and
Urban Affairs
House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

Since the passage of the Garn-St Germain Act the staff of the Federal Savings and Loan Insurance Corporation and the Supervisory Agents in each of the Federal Home Loan Bank districts have been instructed to give the highest priority to minority orientated solutions for troubled minority thrifts. In addition, a representative of the FSLIC has twice made presentations at meetings of the American Savings and Loan League to explain assistance procedures and to answer questions of minority associations.

Only one actual default prevention activity concerning a minority-owned thrift has occurred since the passage of the Act. This involved Valley First Federal Savings, a $32.5 million hispanic association in El Centro, California. Regrettably, there were no geographically proximate hispanic associations nor were there other "minority" alternatives, and the FSLIC was forced to close and liquidate Valley First. However, its insured accounts were successfully transferred with minimum disruption to Home Federal Savings of San Diego which will continue to serve the El Centro community.

The Bank Board remains committed to giving a high priority to the maintenance of minority-owned thrift institutions and to ensuring continuity of service to the communities they serve.

Sincerely,

/s/ Edwin J. Gray

Edwin J. Gray

ELECTRONIC FUNDS TRANSFER ASSOCIATION
SUITE 1000 1726 M STREET, N.W. WASHINGTON, D.C. 20036 (202) 659-2100

June 18, 1985

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
& Urban Affairs
United States Senate
Washington, D.C.

Dear Mr. Chairman:

The Electronic Funds Transfer Association is pleased to respond to your request to deliver a statement for the record that will describe what has happened during the past year or so with regard to automated teller machine (ATM) networks and the laws that govern them.

This has been a traumatic year for the EFT industry. First, a United States district court decision indicated that national banks could not participate in the interstate shared ATM networks that these banks had spent millions of dollars developing over many years. Then a United States Court of Appeals reversed the lower court and restored the status quo. Now, at least two bills have been introduced in Congress that would again jeopardize the ability of national banks to participate in interstate EFT interchange.

The Electronic Funds Transfer Association urges you and your colleagues to reject any attempt to reshape federal law regarding ATM sharing. Please allow this industry to continue to develop in response to market forces within the confines of the law that has been in effect and familiar to all for the past nine years. We do not believe any federal legislation is needed at this time.

As you may be aware, there has been an enormous proliferation of ATMs over the past few years. Ten years ago there were perhaps four or five thousand ATMs. Today more than 50,000 ATMs have been installed.

There are several reasons for this rapid increase. One important factor has been ever-increasing consumer demand for convenient, 24-hour access to funds on deposit. Another has been the general recognition of ATM benefits by state and federal regulatory authorities, who have raised few objections even when the applicable laws were not crystal clear.

Perhaps the greatest single factor has been the development and the overwhelming success of shared ATM networks. Statistics from a year ago indicate that about 16,000 ATMs were connected to shared networks, and these ATMs were at that time processing approximately 60,000,000 transactions per month, which was about one-third of the total ATM transaction volume. Nearly 65 percent of the financial institutions with ATMs belonged to shared ATM networks, and they had collectively issued over 50 million ATM access cards with shared network logos, representing 67 percent of all debit cards issued in the United States.

Although no hard statistics are available, most experts agree that the number of installed ATMs has increased during the past year by more than 25 percent from 40,000 to over 50,000 ATMs installed. Also the number of institutions that participate in shared ATM networks has increased dramatically, as has the volume of ATM transactions in shared networks.

It is significant that membership in shared ATM networks is common among both large and small financial institutions, and it appears to be equally common among state- and nationally-chartered institutions. In fact, a 1984 survey indicated that almost 40 percent of the institutions that were planning to begin offering ATM services for the first time (mostly small institutions) were planning to do so through membership in a shared system.

Shared ATM systems exist in virtually every state, and these shared systems very often interconnect the ATMs of financial institutions in several states, enabling consumers to obtain cash where they live, where they work and when they are traveling. As of last year, for example, 21 of the 25 largest local or regional shared ATM networks included terminals in two or more states.

Despite the antitrust issues that are associated with joint ventures, the Antitrust Division of the Department of Justice has expressed enthusiasm about the benefits that flow from shared ATM networks. The Justice Department has been pleased to observe how substantially ATM transaction volume increases in shared networks.

In a recent speech, Charles Rule, Acting Assistant Attorney General for the Antitrust Division, described the following efficiencies that derive from ATM sharing: customer convenience increases because of geographic diversity; increased transaction volume enables ATMs, networks and "switches" to capture additional economies of scale; ATM locations may be added that would have been impractical for a single institution or a small group; the need for "brick and mortar" branches decreases; competition for deposit-taking may increase; and more effective

competition between depository and nondepository institutions may hasten the demise of "anachronistic regulatory barriers to competition."

At the same time that ATM sharing has been increasing consumer convenience and industry efficiency, competition between shared networks has increased the quality of the shared systems, has increased the pace of innovation, has exerted downward pressure on prices, and has provided choices for financial institutions. Although some states have mandatory sharing laws that require all terminals to be made available for sharing upon request, very little, if any, ATM sharing has been the result of forced sharing. Most states permit, but do not require, sharing; and the marketplace -- not the law -- has shaped most of today's shared systems.

Last year a United States district court decision threatened to severely upset the way in which ATM sharing has been developing in response to marketplace conditions. In the case of Independent Bankers Association of New York State v. Marine Midland Bank, N.A., the district court in effect struck down the regulations and interpretations of the Comptroller of the Currency that had permitted the development of shared ATM systems involving national banks.

Almost nine years ago, the Comptroller ruled that an ATM which is neither owned nor rented by a national bank is not to be deemed a branch of that national bank merely because that bank's customers may use the ATM in exchange for the payment by that bank of a transaction fee to the ATM-owner. The Comptroller's ruling was based on the express language of the United States Court of Appeals for the District of Columbia in an earlier landmark decision in this area. The EFT industry has in good faith spent many millions of dollars developing shared ATM systems in reliance upon those standards which were first set forth by the Comptroller in 1976.

By holding that a shared ATM is deemed to be the branch of every national bank whose customers use it, the district court in the Marine Midland case threatened to put a halt to all ATM sharing across state lines by national banks, because a national bank is prohibited by federal law from establishing branches outside the state in which it is situated. The district court's decision handed state-chartered banks a major competitive advantage over national banks in the field of retail banking because state banks could continue to participate in interstate shared ATM systems. This favoring of state-banks flew in the face of the federal McFadden Act which had been enacted in 1927 to enhance the powers of national banks and to protect the national banking system. In reality, this blow to national banks

would have adversely affected nearly all shared ATM systems because of the integral role that national banks have played in the structure and operation of these systems.

The potential effects of the district court's decision were so catastrophic for the EFT industry that amicus curiae briefs were filed by the Electronic Funds Transfer Association, the Comptroller of the Currency, the Federal Reserve Board, the Consumer Bankers Association, Visa, Mastercard, a professor of law and numerous shared ATM networks. At the same time, the EFT industry turned to Congress to prevent the interstate shared ATM networks from being shut down.

Late in the last session, Senator Trible introduced a bill entitled the Banking Convenience Act of 1984, which would have preserved the status quo with regard to ATM sharing.1/ That bill did not attempt to write new law regarding the use of ATMs by national banks. Such a task would have been very difficult politically, and its effects would, at best, have been uncertain in the rapidly changing markets for EFT services.

The Banking Convenience Act merely sought to codify into statutory law the interpretation of the McFadden Act that had been the law recognized by all parties since that act was definitively interpretted with regard to ATMs by the Court of Appeals and the Comptroller of the Currency in 1976. The Trible bill was not an attempt to restructure the EFT industry. Rather, it was carefully crafted to maintain the status quo and prevent the shut down of interstate ATM sharing involving national banks.

In February of this year, the United States Court of Appeals for the Second Circuit, reversed the district court in Marine Midland and restored the status quo. That court held that an ATM, which a national bank neither owns nor rents but permits its customer to use on a transaction fee basis, is not a branch of the customer's bank. Accordingly, national banks may continue to participate in shared ATM systems across state lines to the same extent as they have for the past nine years.

The Electronic Funds Transfer Association believes that the Court of Appeals decision in Marine Midland was a great victory for the entire EFT industry and for consumers who use EFT services. It was a victory for big banks and small ones, as well as national banks and state banks. The decision reaffirmed the interpretation of the McFadden Act that has permitted ATM sharing to develop in response to market conditions, and it did so in way

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1/ S. 2989. The Trible bill was reintroduced in the current session as S. 206. An identical bill was introduced in the House of Representatives by Representative LaFalce as H.R. 688.

that causes no disruption to the present operating procedures of shared ATM systems. In our opinion, that is quite an accomplishment.

Thus, the Electronic Funds Transfer Association believes that there is no longer a need to pursue a national legislative solution to the ATM sharing problem, because there is no longer a problem. The Association does not mean to suggest that the current restrictions on the deployment of proprietary ATMs by national banks is necessarily a good policy. Nor does it intend to suggest that national legislation permitting any ATM to be used by any party for any purpose would necessarily be inappropriate.

However, the Association recognizes that those positions and others that could be promoted are politically charged and might, in the short run, favor some groups and disadvantage others. Thus, the Association is satisfied with an interpretation of the law that all parties have lived with for a long time and that has permitted market forces to shape system development.

In the current legislative session certain bills have been introduced with regard to ATM sharing that would reverse the decision of the Court of Appeals in Marine Midland and once again threaten to seriously disrupt the numerous shared ATM networks that have been permitting customers of state and national banks to withdraw cash across state lines for several years. One bill, entitled the Automatic Teller Machine Competitive Equity Act of 1985,[2/] would abolish the "own or rent" standard and make interstate sharing of ATMs by national banks permissible only where state branch banking laws expressly permit it. In most cases today, interstate EFT interchange occurs because of the absence of prohibitions as well as favorable rulings and interpretations. If national interstate interchange required state legislation expressly authorizing each state's national banks to use ATMs in other states and expressly authorizing banks in other states to use its ATMs, there would be no national EFT interchange.

Another ATM sharing bill, entitled the Electronic Banking Competitive Equality Act of 1985,[3/] would make universal terminal sharing and uniform interchange fees a mandatory condition before a national bank could use ATMs across state lines, and it would forbid the use of interstate ATMs for deposit-taking unless expressly authorized by state statute in the state where the universially shared ATMs were located.

2/ H.R. 2099, introduced by Representative Thomas Ridge.

3/ S. 1148, introduced by Senator Proxmire.

This bill is in fundamental conflict with long-established federal antitrust policies. It would sound the death knell for competitive ATM networks by mandating universal ATM sharing as a condition for interstate ATM interchange by national banks. The Justice Department has always been opposed to mandatory sharing laws because "such laws undermine the incentive to innovate, creating a 'free-rider' problem with respect to initial risk-taking." Moreover, "price fixing" is a per se violation of the Sherman Act. Although the courts and the Justice Department have fairly recently declared that uniform interchange fees may be permissible within a single ATM network, that is a far cry from mandatory uniform fees as a condition for interstate interchange. It seems unlikely that a uniform interchange fee to be agreed upon by all networks would be viewed with favor by Justice.

It appears that all of these bills are over-reactions to problems that do not exist. The Court of Appeals in Marine Midland merely affirmed what has been the status quo with regard to ATM interchange for the past nine years. It does not appear that national banks are ignoring state EFT laws or using ATMs to collect deposits across state lines. In fact, prohibitions on interstate deposit-taking through shared ATM networks are contained in state unauthorized banking laws, not the McFadden Act or state branch banking laws, and those unauthorized banking laws should be as effective today as they were before the Marine Midland decision. In the absence of any actual problem, bills like these are bound to create more problems than they solve. The Electronic Funds Transfer Association strongly recommends that Congress take no action at this time that would affect the ability of national banks to continue sharing ATMs across state lines.

The Association greatly appreciates this opportunity to express its views. We ask that you include our statement in the Committee's hearing record on Changes in the Financial Services Industry.

Sincerely yours,

Albert A. Irato

Albert A. Irato
Chairman of the Board
Electronic Funds Transfer Association

President
Financial Card Systems, Inc.
Houston, Texas

AAI/smj
cc: All Senate Banking Committee Members

National Conference of State Legislatures

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President
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State of Tennessee

Executive Director
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Statement
by

Representative Mary McCauley Burrows
House of Representatives
Oregon Legislature

on behalf of

The National Conference of State Legislatures

to the

U.S. Senate Banking, Housing and
Urban Affairs Committee

July 2, 1985

I am Representative Mary McCauley Burrows, a member of the Oregon Legislature and Chair of the National Conference of State Legislatures' Committee on Government Operations and Regulation on whose behalf I am submitting this statement for the record.

The National Conference of State Legislatures (NCSL) is the official representative of and spokesperson for the nation's 7,461 state lawmakers. The organization provides issue research, technical assistance, comprehensive federal budget and funding data and training services for legislators and their staffs. Since its creation in 1975, the organization has also served as the Washington, D.C. liaison for all state territorial and commonwealth legislatures and has promoted policies developed through a State-Federal Assembly. The NCSL Committee which I chair has primary responsibility for monitoring issues regarding financial institutions which are of paramount concern to all states.

-NONBANK BANKS-

While there are many pressing issues involving the long-term stability and regulation of financial institutions which state legislators believe require state and/or Congressional action, NCSL has listed congressional resolution of the "nonbank bank" issue as its major concern.

NCSL is certainly encouraged, Mr. Chairman, by your efforts in 1984 to address this issue conclusively in S. 2851. And, while recent court decisions have satisfied our concerns with the nonbank bank loophole, these are merely temporary solutions. If they are reversed at a higher court level, the loophole will continue to exist. In this regard, NCSL is most willing to lend its

support to ensure that the loophole is closed and encourages you to include it in whatever legislation you might ultimately introduce in the 99th Congress.

Congressional closure of the nonbank bank loophole must be accomplished for several reasons:

First, restrictions on interstate bank ownership and deposit-taking as established under the Bank Holding Company Act and the Douglas Amendment have been ignored. Even with the temporary injunction by a Florida District Court on the Comptroller of the Currency, a permanent solution is sorely needed.

An array of federal laws with which you are quite familiar have outlined quite distinctly a number of controls regarding geographic location, branching privileges and subsidiary ownership of financial institutions. These laws have essentially been circumvented. Why it became essential to overlook these statutory dictates established by Congress certainly concerns both me and NCSL.

I am unaware of any Congressional authorization for the chartering of any limited service nonbank bank. Section 2 of the Bank Holding Company Act specifies that a bank is an institution which accepts deposits available on demand and makes commercial loans. That appears to be as clear as the federal legislative restcictions imposed on the authority to be exercised by the Comptroller of the Currency. If Congress had intended otherwise, I feel states might more likely be discussing the successes and failures, assets and liabilities of nonbank banks rather than loophole closure.

This conclusion is recently supported quite affirmatively in IBAA vs. Conover (U.S. District Court for the Middle District of Florida):

> It is highly unlikely that "Congress intended to remove nonbank banks from the provisions of the BHCA by an amendment passed at a time when nonbank banks did not exist and had not been conceived of."

It is also affirmed more strongly in the recent U.S. Trust case which found that the Federal Reserve Board and U.S. Trust had ignored the Congressionally-imposed prohibition on the "creation of interstate deposit-taking networks of bank holding companies without specific state authorization."

On a related point, interstate banking legislation has generated tremendous concern in most state legislatures in both 1984 and 1985. Despite a flurry of state legislative activity to resolve the complexities of interstate banking, states have had to contend with federal regulatory approval of charters which fly distinctly in the face of laws mandating geographic and jurisdictional constraints and controls.

This certainly generates contradictions and confusion and does not lend itself favorably to the public's perception of the strength, soundness and safety of financial institutions. NCSL would certainly echo the judgment of the U.S. District Court in Florida which stated that:

> "It is the Comptroller, not the plaintiffs, who should seek Congressional authority before imposing his personal policy preferences on interstate banking on the banking structure of the United States." (IBAA v. Conover)

A second reason why the nonbank bank loophole requires closure is that state legislatures, including 12 states which have passed nonbank bank legislation, recognize that Congress must act to settle this issue on a nationwide basis.

Arkansas, North Carolina, Connecticut, Colorado, Florida, Virginia, New Jersey, New Mexico, Kansas, Mississippi, Georgia and my home state have tackled this troublesome problem. It is difficult to say at this point exactly how many states will ultimately address this issue in their 1985 sessions. Those states which have taken action have done so for reasons exemplified in the following summaries:

> "--these companies (nonbank) banks avoid regulatory controls designed to promote the safety and soundness of institutions which accept deposits." (New Jersey, Assembly Bill 3120, 1985 session)
>
> "---(The intent of this bill) is to block to the extent possible the arguably extralegal actions of companies setting up non-bank banks through a non-intentional loophole in federal law." (Florida, H Bill #10A, 1984)
>
> "no bank holding company or any other company may acquire or control any banking institution in this state that does not accept (demand) deposits --- and engage in the business of making commercial loans." (Colorado, SB47, 1985 session)

The results of these legislative actions have differed. Some states as New Jersey, have placed a moratorium on the chartering of nonbank banks. Others

have defined "bank" to be what is already set out in federal law or have opted for a definition of their own. The results have not been uniform and explains, in part, why NCSL feels the loophole must be closed by Congress. In some instances (F]orida and New Jersey), there are sunset dates established in the hope of conclusive Congressional action.

A third reason for closing the loophole is to prompt the dismissal of all applications before federal regulators for nonbank bank chartering. As I mentioned earlier, NCSL has been concerned with how any charters were ever authorized because such action flies in the face of federal law.

NCSL firmly believes that what currently number nearly 400 nonbank bank applications should not receive final approval. By virtue of recent court action, the Comptroller and Federal Reserve Board have imposed what is, I believe, a third moratorium on approval of applications. These moratoriums, even the current one which responds to court action, highly suggest that there has been not only uncertainty as to the legitimacy of granting limited service charters, but also recognition that a variety of national laws have been blindsided. As a state legislator, I am not at all inclined to have regulatory bodies do my job. I am confident that you, as national lawmakers, feel likewise about federal regulators.

NCSL would further encourage all Senators to cosponsor and support a proposed sense of the Senate resolution, being sponsored by Senators Heinz, Proxmire, Bumpers and Trible, which speaks to the issue of loophole closure. While legislation clarifying the definition of a nonbank bank is very much preferred, this resolution might be an effective tool should passage of legislation in both houses become a problem and during confirmation hearings of a new Comptroller.

INTERSTATE BANKING

Several bills introduced in the 99th Congress provide different mechanisms for Congress to tackle this complex issue. NCSL policy on interstate banking is very straightforward. The wisest decisions which our organization feels can be made regarding nationwide interstate banking, triggers and regional compacts would include the following ingredients:

- Individual state legislatures should be left to determine whether conditional, unconditional or regionally exclusive geographic expansion is desirable. NCSL does not feel that there is any compelling urgency or need to mandate federally any form of nationwide interstate banking. Obviously, the recently decided Northeast Bancorp case addresses our concerns quite conclusively. There no longer appears to be any need to pass federal legislation regarding this issue.

Nevada, Tennessee, Maryland, Virginia and Arizona and my home state of Oregon are six examples of states which have most recently sanctioned some form of interstate banking. This brings to 24 the number of states which have enacted interstate banking legislation since 1983. Arizona (like Maine and Alaska) chose to go nationwide interstate while the others have agreed upon varying forms of regional agreements typically achievable through reciprocity, although my home state rejected reciprocity. Just as critical as these decisions are those actions taken to date in Arkansas, Missouri, New Hampshire, New Mexico, Texas and Nebraska where interstate banking legislation has died or been tabled.

To superimpose any form of federally mandated nationwide interstate banking at this time would serve to upset the balance and strength generated by current policy. Those states which have sanctioned reciprocal regional compacts for full nationwide interstate banking are serving as laboratories for all others. We may discover in time (and there is no way for me to specify how long this "lab" time would be) that either nationwide or limited regional interstate banking is the preferable route to take. But, we need time to draw definitive comparisons rather than a Congressional rush to a potentially harmful conclusion.

Possibly the strongest reason for maintaining the status quo on how interstate banking is authorized is that states, not Congress, are best postured to determine: 1) what is best both economically and financially for a state 2) how to control economic concentration and yet remain an attractive place for financial institutions home-based in other jurisdictions, and 3) with which states it is most advantageous to do business. None of these strengths in any way circumvents the commerce clause of the U.S. Consitition as has been suggested by plaintiffs in litigation which challenged the regional agreements drawn by Massachusetts and Connecticut. To argue otherwise is to <u>compel</u> the citizens of my state to have many financial and economic development matters potentially controlled by Californians, New Yorkers or Nevadans. While I have nothing against anybody from these states, I do not want them to tell my state how and with whom I must do banking business.

Market expansion does not necessarily lead to reduced competition. Likewise, reciprocal compacts do not necessarily impact negatively on competition. Undue concentrations of economic power are not necessarily the result of interstate banking. These conclusions have been reached from very

small pieces of evidence from states with brief experiential histories with reciprocity. The converse is certainly feasible and that possibility reinforces my concern with any federally authorized interstate banking mandate.

Congress should not necessarily conclude that state approval of interstate banking legislation is a wholehearted endorsement of this issue. There is no doubt that it simplifies a state's ability to rescue faltering institutions. The Bank of America recently took over one of Oregon's largest banks because our home state institution was failing. There were virtually no other options available to the Legislature other than the interstate banking route to ease acquisitions. Oregon might not ever again be confronted with a similar situation. However, we would not want a strong institution being absorbed by a financial giant merely wishing to expand its territory.

- Regional agreements, reciprocal or nonreciprocal, should be retained as a matter for states to determine and establish. NCSL would support further Congressional sanctioning of those compacts already in place or to be structured in future years. But as I mentioned earlier, the Northeast Bancorp decision renders any action as virtually unnecessary.

- Triggers for nationwide interstate banking are another matter best left to state discretion. As I mentioned earlier, there is absolutely no urgency or need, whether it be 1,2,3 and 5 years, to compel states to partake of nationwide interstate banking and simultaneously take away the opportunity to prohibit it.

EXPANDED POWERS

During your hearings conducted both in 1984 and 1985, you have had proposed to your Committee an entire smorgasbord of potential powers for financial institutions. While NCSL has not studied or reviewed each and every one of these possibilities, there are particular benchmarks and priority concerns which we feel are of critical importance.

- If additional powers are to be granted financial institutions, NCSL urges Congress to ensure that neither the safety nor soundness of existing institutions be jeopardized. The number of failing and troublesome bank operations causes NCSL serious concern not only because it primarily shakes consumer confidence but also because it demonstrates that investment practices, management styles and supervision are too often substandard or misguided. To merely grant new powers without first insuring sound operations would be equivalent to placing the cart before the horse.

- NCSL strongly supports a healthy and fair competitive financial institutions structure and recognizes that there are many commercial entities today that are conducting traditional banking business. This does not compel us to support a blanket proposition to grant numerous expanded powers. It does, however, incline our organization to encourage Congress to examine those powers which might ultimately serve to strengthen competition and broader consumer services and benefits. To the extent that such a Congressional examination might leave uncertainty or unestimable competitive impact, then NCSL would urge caution.

- State-chartered institutions have served the dual banking system quite well as testing grounds for usage of what would be expanded powers for federally-chartered institutions. In general, states have been vigilant about the impact that new powers have in promoting the stability and competitiveness of small institutions. NCSL feels that this particular yardstick of vigilance should be made a measure of any Congressional authorization of expanded powers.

- Finally, NCSL strongly endorses authorization of commercial bank underwriting of municipal revenue bonds. Granting this power would likely increase competition for revenue bonds and thereby reduce the cost attributable to revenue bond financing. This is our priority concern and I would urge the Committee to support its inclusion in legislation which is ultimately introduced once your hearings have been concluded.

DEPOSIT INSURANCE

Due to the unfortunately healthy number of bank failures, federal identification of "problem financial institutions, and the thrift crises which have recently occurred in Ohio and Maryland particularly, NCSL was prompted to take a preliminary look at the ability of existing insurance modes to protect depositors against bank failures and to ensure financial stablility. While we are continuing to review the existing situation and weigh alternatives, NCSL has reached some initial policy conclusions:

- Congress should seriously examine legislation which would establish variable risk, federal deposit insurance. Both FDIC and FSLIC have come forth with legislative proposals and I encourage the Committee to review

them closely. Like several other organizations, we are uncertain of precisely how to implement it most effectively and how to ensure that objective criteria, which make no institution fail-proof, are established. Nevertheless, this idea is one which might well serve to bolster the stability of financial institutions, whether state-or federally-chartered.

- NCSL sees no reason why states should not have the option to utilize either private or state-created deposit insurance sources. In light of recent crises, it is certainly incumbent upon the states to periodically review their non-federal deposit insurance services so that adequacy and stability can be objectively measured. Situations as those arising in Maryland and Ohio were not caused by private or state sanctioned deposit insurance. Nevertheless, there are linkages which poignantly demonstrate that increased state monitoring of these deposit insurance options are extremely critical.

There have been suggestions that states meet Federal guidelines if they desire to pursue a non-Federal deposit insurance alternative. NCSL is not at all convinced that Federal guidelines are the kind of regulatory adjustment which would most effectively enhance the integrity of financial institution operations. Guidelines alone would tend to put federal regulators in a position of being a sole insuror. NCSL believes there are potential marketplace benefits, enhanced competition and fewer monopolistic regulatory tendencies if private insurance options are retained.

AUTOMATED TELLER MACHINES

While this issue has not shared in the headlines attributed to other banking matters, recent court judgments have thrown a cloud over what already was a somewhat blurred subject matter.

NCSL fully recognizes that electronic banking continues to evolve and presents potentially enormous opportunities for streamlining and expanding consumer services. While there is no reason to snag progress, NCSL is concerned not only with services and convenience but also with economic, financial and geographic matters which are linked with the current and future growth of these devices.

Definitely at issue is whether shared automated teller machine networks are branches and whether Congress should reinforce the state's structural and statutory prerogative to control the functions and location of these devices. The National Conference of State Legislatures urges you to examine closely Senator Proxmire's S.1148 and Congressman Ridge's 2099 since they provide a reasonable clarification to an issue blurred by past regulatory interpretations and recent judicial decisions.

The National Conference of State Legislatures has adopted policy which:

- o supports use of automated teller machines and electronic banking devices by national banks to the extent each state permits its state-chartered banks to use this equipment;

- supports interstate branching by national banks through electronic and automated devices when both the exporting and importing states sanction such activities; and

- supports state control over the functions, including deposit taking, for which automated and electronic banking equipment may be utilized.

It is our belief that electronic banking devices constitute branches and therefore are subject to state control. This belief extends to all shared and free-standing networks and machines which are owned, rented or used by national banks.

To ensure competitive equity, however, NCSL feels that legislation is necessary to place state and national banks on equal footing. The recent decisions in IBANYS V. Marine Midland have preempted an entire body of state law and left national banks with a serious competitive edge. Additional litigation has already surfaced and NCSL feels that this matter can best be addressed now through Congressional action rather than inconsistent judicial directives.

Arguments have been put forth, such as in the Marine Midland case, that electronic banking devices are not branches when they are not owned by a national bank or rented from another national bank. This posture serves to open the door to preempting state control over specific banking activities and potentially undermining much-needed competitive equity which has been endangered through the aforementioned court judgment.

NCSL is more than willing to cooperate with the Committee in addressing this issue and exploring various solutions so that states and the federal government avoid full reliance on judicial interpretation.

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STATE AUTHORITY OVER STATE-CHARTERED BANKS

NCSL policy spells out the organization's opposition to any broad, unwarranted preemption of state authority granted by statutory or regulatory means to state-chartered instutitions. While NCSL did not actively participate in the debate over the Dodd Amendment within S.2851, I would certainly urge the Committee to develop an option much like the original language in S.2851.

What has been popularly referred to as the "South Dakota loophole" does not necessarily require a Congressional response insofar as NCSL is concerned. However, if it is again addressed in 1985 in legislation, we would encourage development of a stance which retains state authority over state-chartered banks within individual state borders. Simultaneously, these banks could not be used to avoid limitations on the interstate operations of non-banking subsidiaries of bank holding companies.

ANSWER # 4

National Council of Savings Institutions
Rebecca H. Laird
Vice President and
Chief Regulatory Counsel

July 30, 1984

Mr. Hoyle L. Robinson
Executive Secretary
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429

Re: Proposed Statement of Policy
Regarding the Availability and Use
of Financial and Other Information
by Depositors and Other Creditors
of Banks and Thrifts

Dear Mr. Robinson:

The National Council of Savings Institutions, representing approximately 600 members whose assets approximate $400 billion, welcomes the opportunity to comment on the FDIC's proposed Policy Statement concerning disclosure.

The statement seeks to encourage depositors and creditors to request certain publicly available information and other information from insured banks. For example, depositors are encouraged to request the Call Reports, the Uniform Bank Performance Reports (UBPRs) and Country Exposure information. In addition, insured banks are encouraged to prepare narrative papers describing problems and weaknesses and such other material factors about the insured bank plus provide information on any formal or informal supervisory action against the bank. The basis for the proposed FDIC action, as described in the preamble, is "to promote discipline in the marketplace." As deregulation proceeds, the FDIC asserts that market discipline becomes increasingly important "to limit destructive competition and excessive risk-taking." Further, disclosure is essential to the proper functioning of the marketplace discipline concept.

While in broad principle, the National Council cannot disagree with any of these statements, we do not believe that the proposed policy statement meets these objectives. In fact, it could be argued that under present law and practice, it may work against ensuring a properly functioning financial system in this country.

1101 Fifteenth Street, N.W., Washington, D.C. 20005 / (202)331-0270

As a preliminary matter, we would note that most insured banks (certainly all the commercial banks), are in the stock form. As stock institutions, those that are publicly held have to make extensive disclosures to their stockholders under the securities laws. Thus, disclosure as related to those investors who have funds at risk generally exists now.

However, considering the broader question of encouraging disclosure to depositors, as well as stockholders, we have the following views.

The major reason that this policy statement is ill-conceived is that the depositor with less than $100,000 deposited in an insured bank, or with no uninsured funds, has no interest and indeed should have no interest in the financial health of the institution in which he or she has deposited funds. Whatever the financial institution's condition, the depositor's funds are not at risk, instead, the FDIC funds are at risk. Thus, as a simple economic matter the depositor, under present law, has no reason to inquire about the financial condition of an institution whose accounts are insured by the FDIC. Of course, the law could, and arguably should, be changed, but until such action is taken there is no economic incentive for a depositor to seek greater disclosure.

For the "sophisticated depositor," or those individuals who have uninsured funds invested in an insured bank, whose uninsured funds are at risk, there is a great deal of economic incentive to placing the funds in institutions which will not be placed in receivership by the FDIC. Generally, we believe that sophisticated depositors do seek as much information as possible about the institution in which they invest funds to protect themselves. However, even in this situation, under present FDIC procedures, it is not necessary to make fine distinctions between well-run and less well-run institutions. Sophisticated depositors can be equally comfortable placing funds in only the very largest institutions, which they believe will not be liquidated.

Thus, under present law and procedure, we believe that there is no economic incentive which will be fostered by the proposed policy statement.

Conversely, we believe that the policy statement may actually cause harm by requiring disclosure, which could be used irresponsibly to question the stability of an institution, thereby creating problems for the financial system and the insurance agency. If institutions are required to report, upon request, that they are a party to a memorandum of understanding or other type of supervisory order, and that information is publicized, it may well cause a lack of confidence in the institution, resulting in depositors withdrawing their funds. This can only hurt the institution and thus increase the problem for the FDIC. Furthermore, existing understandings were signed when institutions believed that they would be kept confidential. If all such agreements have to be made public, it is possible that it will be more difficult for the FDIC to get institutions to sign the agreements. In

conclusion, we can not understand why the FDIC would want to undermine public confidence, needlessly. Present law and procedure were not designed for full disclosure and the exercise of market discipline. Thus, we can see no benefit to this proposal and possible harm. As such, we can not support it.

Sincerely,

Rebecca H. Laird

Rebecca H. Laird
Vice President

For #13

National Council of Savings Institutions
James J. Butera
Group Vice President for
Legislative and Regulatory Policy

July 9, 1985

The Honorable Alfonse D'Amato
Chairman
Securities Subcommittee of the
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D. C. 20510

Dear Mr. Chairman:

The National Council of Savings Institutions, on behalf of its 600 savings bank and savings and loan members, is pleased to submit these views on pending legislative proposals (S. 975, S. 1016 and S. 1286) to curtail the use of certain types of debt instruments, known variously as "high yield", "growth" or "junk" bonds. These legislative proposals, which would also limit the authority of federally insured depository institutions to invest in "noninvestment grade securities," were reviewed by the National Council's Committee on Asset and Liability Management at its May 1985 meeting. It was the unanimous view of the savings industry executives serving on that Committee that the enactment of legislation in this area is neither neceesary nor justified at this time.

Like many emerging and innovative corporate finance activities, high yield bonds are not appropriate for every institution's portfolio. The higher yields must be weighed against the prospect of additional losses, the consequences of reduced liquidity and the additional managerial time required to monitor the market. However, evaluations of this type represent the very essence of managing financial institutions, and should therefore be viewed as the proper function of private sector judgments rather than governmental action. Since the proponents of the pending bills have not been able to demonstrate that the default ratio on noninvestment grade securities is substantially different than that of bonds carrying higher ratings, we see no reason to preempt the workings of the financial markets.

Even if the case could be made that investment in high yield bonds issued in connection with corporate acquisitions constitute a threat to the safety and soundness of insured institutions, we believe it critical that Congress recognize that there are numerous other uses of noninvestment grade securities. In fact, most noninvestment grade or unrated bonds have nothing to do with takeover financing, but are issued by companies which have an insufficient operating history to command an investment quality rating from Moody's, Standards and Poors, or the other principal rating agencies. Another major category of issuers are those companies which have had credit problems that resulted in rating downgradings (steel, certain utilities, etc.).

Recently, the National Council conducted a special survey of our members on this subject and the results indicate that approximately 35 per cent of the nation's approximately 400 savings banks hold nonrated securities in their portfolios. A lower but still substantial 6 per cent of savings and loan associations responding to the survey also indicated investments of this type. The important point turned up by our survey is that over 98 per cent of the holdings of nonrated securities by savings institutions are bonds which are not related to financing corporate acquisitions.

This is significant because as we interpret the language of the pending bills, all holdings of below investment grade and unrated bonds would be prohibited. This would accomplish nothing by way of promoting safety and soundness and would cover many situations where savings banks and savings and loan associations have invested in local companies, both public and private, as a means of supporting their local economies. These investments, which run in the billions of dollars, would be banned under the terms of all the pending bills. We respectfully suggest that this result, while perhaps unintended, nevertheless points up the extreme difficulty of drafting statutory language to control market developments which are subject to innumerable variations and frequent innovations.

While the pending bills contemplate a prospective ban, thereby avoiding problems relating to divestiture, this should not be viewed as eliminating the adverse impact of such a step on institutions holding noninvestment grade securities. Legislation prohibiting thousands of present and potential market participants from purchasing these types of debt instruments will severely curtail the marketability of the bonds, not to mention the actual value of the assets now held in portfolio.

As an alternative, we would suggest that, to the extent the Congress has identified a problem in this area, it would be much better to address it through a general directive to the federal financial supervisory agencies to handle the matter by administrative rulemaking. The Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board could readily fashion regulations that are more limited and flexible than an outright statutory ban. In fact, the FHLBB has already proposed regulations circumscribing investments of this type by institutions under its jurisdiction to ensure that they are sufficiently diversified and subject to a number of other prudential criteria.

Thank you very much for taking these views into consideration; we request that this letter be made a part of the formal hearing record.

Sincerely yours,

James J. Butera
Group Vice President

For #13

National Council of Savings Institutions
John A. Tuccillo
Vice President and Director
Research and Economics

July 8, 1985

SURVEY ON BELOW INVESTMENT GRADE SECURITIES

We have done a tabulation of the responses to date to the survey on below-investment grade securities, and the highlights are as follows:

1. We received responses from 353 institutions, or over half our membership. Of these, 250 are savings banks and the remainder savings and loans.

2. Seventy (70) percent of all institutions hold no bonds rated below-investment grade. Sixty-five (65) percent of savings banks responding and 94 percent of savings and loans hold no below-investment grade paper.

3. For those institutions that do hold low-grade securities, the average holding is $3.59 million. For savings banks this average is $2.79 million; for savings and loans it is $24.03 million.

4. Only two institutions reported holding below-investment grade paper specifically issued to finance corporate takeover activity. Average holdings of these securities were $3.75 million.

5. For the most part, below-investment grade holdings represented the paper of local public institutions.

John A. Tuccillo

1101 Fifteenth Street, N.W., Washington, D.C. 20005 / (202)331-0270

BANK OF AMERICA

PATRICK S. ANTRIM
Senior Counsel

August 13, 1985

Virginia Anne Housum
Counsel
Committee on Banking, Housing, and
Urban Affairs
U.S. Senate
Washington, D.C. 20510

Dear Ms. Housum:

This is in response to your letter to Karen Shaw concerning written testimony recently provided by a representative of the SIA on mortgage backed securities.

I have enclosed for your information background material concerning the bank's victimization by the NMEC pool scheme. As this material makes abundantly clear, and contrary to the statements in the SIA testimony, Bank of America's role in the NMEC affair was limited to escrow agent and trustee. Anyone who made even a perfunctory review of the press accounts of this matter would know that the bank did not create, issue, sell, or arrange for the sale of these certificates, nor did it hire any other institution or individual to perform any aspect of these transactions on its behalf. The certificates involved are not related in any way to the bank's own mortgage pass-through programs, which have provided successful investment vehicles for both investors and the bank. The SIA testimony, therefore, is inexplicable.

In fact, the NMEC scheme has nothing to do with underwriting or issuing mortgage-backed securities as an identifiable activity. It deals with fraud on the part of nonregulated sellers of mortgages to institutional purchasers. The role played by regulated depository institutions, as escrow agent, trustee, and purchasers was in the normal course of their businesses. Indeed, if institutions such as Bank of America had the legal capability to underwrite securities backed by their own mortgages, incidents of this nature would be far less likely to occur.

If I can provide you further information on the NMEC situation, please give me a call.

Sincerely yours,

Patrick S. Antrim
Senior Counsel

NATIONAL MORTGAGE EQUITY CORPORATION MORTGAGE

POOL SCHEME - BANK OF AMERICA'S SUMMARY

I. INTRODUCTION

This Memorandum describes the nature of the fraudulent scheme perpetrated by National Mortgage Equity Corporation ("NMEC") and other entities and individuals upon Bank of America and investors in the NMEC mortgage pools.

From 1982 to 1984, Bank of America served as escrow agent in connection with certain mortgage-pass-through-certificates packaged and marketed by NMEC. Bank of America also served as trustee with respect to those pass-through certificates from January 1983 through October 1984 under the provisions of a Pooling and Servicing Agreement.

II. THE RELEVANT PARTIES

NMEC is a Delaware corporation which maintained its principal place of business in Palos Verdes, California. Beginning in 1982 and continuing through late 1984, NMEC marketed and issued more than $133 million in pass-through certificates to the Investor Institutions described below using the escrow and trust services of Bank of America.

The following Investor Institutions purchased pass-through certificates through NMEC: The Seamen's Bank for Savings, Liberty Federal Savings and Loan Association, Whitestone Savings and Loan, First Federal Savings of Philadelphia, Irving Savings and Loan Association, Columbia Federal Savings Bank, Provident Savings and Loan, Oneonta Federal Savings and Loan Association, United Federal Savings Bank of Iowa, Beacon Federal Savings and Loan Association, Bay Ridge Federal Savings, Riverhead Savins and Loan, Missouri Savings Association, City Federal Savings and Loan Association, Citizens Federal Savings and Loan Association of Cleveland, Anchor Savings Bank FSB, South Weymouth Savings Bank, Richmond Hill Savings Bank, and Fidelity Savings Association.

David A. Feldman ("Feldman") promoted, organized and managed NMEC beginning in 1980. Feldman, a graduate of West Point, is a convicted felon, having been found guilty in February 1982 before the United States District Court for the Northern District of Illinois of 19 counts of mail fraud (18 U.S.C. S 1341) and 9 counts of wire fraud (18 U.S.C. S 1343) in connection with a swindle he perpetrated when employed by the brokerage firm of Merrill, Lynch, Pierce, Fenner and Smith, Inc. Between 1980 and March 1984, when he began serving his prison sentence, Feldman was the president of NMEC.

Defendant Lord, Bissell & Brock ("Lord Bissell") is a Chicago law firm which, between 1980 and October 1984, acted as legal counsel for NMEC in connection with NMEC's packaging, marketing, and servicing of pass-through certificates.

Leslie W. Michael ("Michael") is the law partner in the Lord Bissell law firm who was principally responsible for the conduct and handling of NMEC's legal affairs. Michael assisted and participated with Defendant Feldman, a relative of his, in the organization of NMEC. Michael and his immediate family held a substantial ownership position in NMEC and Michael served as an officer on NMEC.

West-Pac Corporation ("West-Pac") is a Nevada corporation with its principal place of business in Orange, California. West-Pac was the purported borrower in connectin with a substantial number of fraudulent real estate loans pooled by NMEC for sale to the Investor Institutions. West-Pac acted in concert with NMEC with respect to the real estate loans extended to West-Pac.

Kent B. Rogers ("Rogers") was the principal organizer of West-Pac and acted as its president in connection with West-Pac's transactions with NMEC. Rogers is presently an inmate in the Federal Correctional Institution at Lompoc, California. In February 1982, Rogers was convicted in the Unites States District Court for the Central District of California of substantive bankruptcy fraud (18 U.S.C. S 152) and conspiracy to commit bankruptcy fraud (18 U.S.C. S 371) as a result of his concealment of real property assets, fraudulent receipt of money, and deliberate withholding of documents and records from a court-appointed trustee.

III. SALE BY NMEC OF MORTGAGE-PASS-THROUGH CERTIFICATES

From 1981 to late 1984, NMEC engaged in the business of marketing and issuing Mortgage Pass-Through Certificates ("Certificates") representing undivided interests in pools of real estate loans secured by first or second deeds of trust on residential properties located principally in the states of California and Texas. Each Certificate represented what was in essence a bundle of mortgages collected by NMEC for sale to financial institutions at a price equal to the aggregate principal balances of the mortgage loans in each particular pool. The financial institution purchasing the Certificate received interest at a "pass-through" rate, that is, a fixed rate stated in the Certificate regardless of the interest rates paid on individual mortgages in the pool.

NMEC contacted financial and thrift institutions to purchase its Certificates through a Private Placement Memorandum. An Investor Institution that agreed to purchase a Certificate signed a letter agreement ("Commitment Letter") also executed by NMEC setting forth the basic terms of the investment agreement. The Investor Institution then transmitted the requisite funds to Bank of America, as escrow agent, for disposition by NMEC. During the years 1982, 1983, and 1984, NMEC sold Certificates on the following terms to the following Investor Institutions:

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Investor Institution	NMEC Certificate Series (Date)	Aggregate Investment (As of 12/15/84)
(a) The Seamen's Bank For Savings New York, New York	Series L-83 (10/3/83) Series D-84 (2/2/84	$ 19,563,436
(b) Liberty Federal Savings and Loan Association Philadelphia, Pennsylvania	Series C-84 (1/31/84)	$ 5,125,637
(c) Whitestone Savings and Loan Whitestone, New York	Series H-84 (3/6/84)	$ 6,194,285
(d) First Federal Savings Philadelphia Philadelphia, Pennsylvania	Series O-83 (11/14/83)	$ 4,999,560
(e) Irving Savings and Loan Association North Haledon, New Jersey	Series G-82 (11/4/82) Series F-83 (6/14/83) Series Q-83 (12/13/83)	$ 17,849,114
(f) Columbia Federal Savings Bank Woodhaven, New York	Series G-84 (2/16/84) Series H-83 (7/7/83)	$ 9,056,370
(g) Provident Savings and Loan Haverstraw, New York	Series P-83 (11/4/83)	$ 5,020,568
(h) Oneonta Federal Savings and Loan Association Oneonta, New York	Series M-83 (10/5/83)	$ 4,027,233
(i) United Federal Savings and of Iowa Des Moines, Iowa	Series S-83 (12/29/83	$ 4,988,758
(j) Beacon Federal Savings and Loan Association Baldwin, New York	Series B-84 (1/19/84)	$ 4,952,617
(k) Bay Ridge Federal Savings Brooklyn, New York	Series Unspecified (3/10/83)	$ 2,000,000

(l) Riverhead Savings and Loan Riverhead, New York	Series E-84 (2/10/84) Series A-83 (1/4/83) Series R-83 (12/19/83)	$ 14,054,937
(m) Missouri Savings Association St. Louis, Missouri	Series B-83 (1/20/83)	$ 10,811,554
(n) City Federal Savings and Loan Association Birmingham, Alabama	Series I-83 (5/2/83)	$ 3,440,557
(o) Citizens Federal Savings and Loan Association of Cleveland Cleveland, Ohio	Series F-82 (9/13/82)	$ 2,171,896
(p) Anchor Savings Bank FSB Hewlett, New York	Series C-83 (4/12/83)	$ 4,893,689
(q) South Weymouth Savings Bank South Weymouth, Massachusetts	Series G-83 (6/16/83)	$ 4,918,315
(r) Richmond Hill Savings Bank Floral Park, New York	Series A-84 (1/16/84)	$ 4,046,401
(s) Fidelity Savings Association Pittsburgh, Pennsylvania	Series H-82 (12/1/82)	$ 5,098,456
		$133,213,383

Pursuant to its agreements with Investor Institutions, NMEC was required to assemble and deliver to escrow real estate loans conforming to certain requirements set out in the Private Placement Memorandum before the investors' funds would be distributed from escrow. In addition to requirements concerning the terms of loan, qualifications of borrower, and nature of properties securing the loan, each loan was to be protected by private mortgage insurance or a financial guarantee bond. NMEC also was required to obtain a written appraisal report on each property by an independent appraiser who had personally inspected the property.

NMEC also was required to forward to the escrow agent certain documentation for each loan assembled. The escrow agent was to disburse funds to NMEC on a loan-by-loan basis upon receipt of the proper documentation.

After the total funds in an individual escrow had been disbursed, the escrow agent was to close the escrow and forward the documentation for each pool to the Los Angeles District Trust Office of Bank of America. Upon receipt of the documentation, the trustee was to accept assignment of all of NMEC's interest in the mortgage loans on behalf of the Investor Institutions and to authenticate and deliver to NMEC a Certificate evidencing the investor's ownership interest in the trust fund mortgage pool.

NMEC acted as the Servicer responsible for collecting all payments from the borrowers on the pooled loans and disbursing to the Investor Institutions on a monthly basis payments reflecting their interests in the repective pools.

IV. REPRESENTATIVES MADE BY NMEC AND OTHERS IN CONNECTION WITH THE NMEC TRANSACTIONS.

NMEC, Feldman, Lord Bissell, Michael, West-Pac and Rogers ("collectively referred to hereinafter as defendants") have been sued by Bank of America in a federal lawsuit brought in the Central District of California for violation of securities laws, fraud and breach of contract.

Defendants represented to the Bank and Investor Institutions that the pass-through certificates marketed by NMEC constituted a valid investment consisting of seasoned bona fide real estate loans initially made, and subsequently acquired by NMEC, in arm's-length transactions. The loans were to be secured by a diverse group of high quality residential properties providing substantial equity in excess of the debt. Defendants represented that the borrowers on the pool loans intended to and were realistically able to service the debt on those loans. In addition, the Defendants represented that investors were offered further protection for their investments as each loan was fully insured by valid mortgage insurance or a financial guarantee bond. In short, Defendants represented that by purchasing the pass-through certificates, the Investor Institutions were purchasing seasoned, bona fide, valuable loans subject to a relatively low level of risk.

V. THE PRIVATE PLACEMENT MEMORANDUM AND THE POOLING AND SERVICING AGREEMENT

The pass through certificates were marketed pursuant to a Private Placement Memorandum ("Placement Memorandum") prepared by Lord Bissell and Michael as counsel for NMEC and Feldman, and transmitted by or on behalf of NMEC to each of the Investor Institutions.

The Placement Memorandum provided that the Certificates would be issued pursuant to a Pooling and Servicing Agreement

("Servicing Agreement") between NMEC as organizer and servicer of the loans and the Bank as trustee. In both the Placement Memorandum and the Servicing Agreement, NMEC, Feldman, Lord Bissell, and Michael made a number of specific representations and warranties to the Bank and the Investor Institutions concerning: (a) the loans, borrowers, and mortgaged properties that would constitute the obligations underlying and securing the Certificates; and (b) the provisions for mortgage insurance that purported to guarantee performance of tall payment obligations owed to the Investor Institutions.

The representations in the Placement Memorandum and the Servicing Agreement pertaining to the mortgages to be pooled consisted of the following:

(a) Each loan would meet NMEC's credit, appraisal and underwriting standards as well as underwriting criteria established by the supplying broker and the insurer. These criteria expressly included standards concerning the maximum and minimum loan amount, maximum combined loan-to-value ratio (including any senior indebtedness), total indebtedness of the borrower, credit history of the borrower, and current property appraisals;

(b) Independent appraisers would make a personal ispection of each mortgaged property and complete a written appraisal report at the time the loan was originated;

(c) Each borrower would submit a credit application that set forth assets, liabilities, income, credit history, employment history and certain other personal information. NMEC was to apply its underwriting standards to the information contained in the credit applications;

(d) The value of the property being financed supported, and reasonably could be expected to support, the aggregate of the first and second mortgage loan balances with sufficient equity remaining to mitigate adverse shifts in real estate values;

(e) The maximum amount loaned on any property would be $500,000 and the combined loan-to-value ratio with respect to each loan would not exceed 80% of the appraised value of the mortgaged property based on appraisals provided by independent appraisal firms;

(f) Each mortgage loan would relate to a one- to four-unit residential dwelling;

(g) NMEC had had good title to and had been the sole owner of each mortgage loan and a standard coverage lender's title insurance policy would be effective for each;

(h) No mortgage loan or first mortgage on the related property would be thirty or more days delinquent; and

(i) The physical property subject to any mortgage would be to NMEC's knowledge free of damage and in good repair.

Pursuant to the terms of the Servicing Agreement, NMEC further agreed:

(a) To notify the Bank as trustee of any breach of any of the above representations that might adversely affect the investors' interests;

(b) To cure any breach in all respects or repurchase the mortgage loan from the trustee with sixty days;

(c) To provide the trustee with a monthly statement showing the aggregate of credits to and charges against each certificate account;

(d) To provide annually a certification by an officer stating that he had reviewed NMEC's activities during the preceding calendar year and that NMEC had fulfilled faithfully all of its obligations under the Servicing Agreement; and

(e) To secure annual statements by independent public accountants certifying that NMEC had performed its servicing operations in compliance with the Servicing Agreement.

Defendants NMEC, Feldman, Lord Bissell and Michael represented in the Placement Memorandum and the Servicing Agreement that either private mortgage insurance or a financial guarantee bond would be obtained with respect to each loan; that the surety bonding company would conduct an independent underwriting verification to ensure that each loan was originated in accordance with preagreed underwriting criteria; that insurance coverage would extend to 100% of the prinicipal amount of each loan; that Glacier General Assurance Company ("Glacier General") and Pacific American Insurance Company ("Pacific American"), the primary insurers, were financially capable of covering the level of anticipated defaults; and that Pacific American had secured reinsurance of a substantial portion of its surety risk with International Indemnity Corporation, which in turn reinsured its risk under treaties with approximately 100 carriers active in the international reinsurance market.

VI. THE WEST-PAC LOAN TRANSACTIONS

West-Pac was the mortgagor on a large number of the loans placed by NMEC into the pools backing the Certificates. On numerous occasions West-Pac and Rogers obtained large sums of money from NMEC -- consisting of funds deposited into escrow by the Investor Institutions -- and used those sums to purchase certain properties, including apartment complexes.

For example, from approximately June through November

1983, West-Pac sought and obtained from NMEC funds that West-Pac then used, with NMEC's knowledge and consent, to purchase a number of apartment complexes in Houston, Texas. These properties included the Oxford Court Apartments at 1701 Upland Drive, and apartment complex at 8250 Park Place Boulevard, and an apartment complex at 8515 Hammerly Boulevard. These three properties involved an aggregate of 640 units. In each case, West-Pac and Rogers obtained fraudulent appraisals on the properties, which NMEC and Feldman knew to be fraudulent. West-Pac and Rogers then obtained, through NMEC and Feldman, funds from the Investor Institutions based upon 80% of the inflated value.

In connection with these transactions in which West-Pac acted as borrower, West-Pac and Rogers represented to the Bank and the Investor Institutions that West-Pac was a bona fide borrower, that it executed the promissory notes that were subsequently assigned to NMEC with the intention and the ability to honor them, that the deeds of trust assigned in connection with the loans constituted good and valuable security for the notes, and that the appraisals on the properties were valid and proper.

VII. THE FRAUDULENT SCHEME

The mortgages contained in the pools were wholly different from those expected by the investors. In flagrant contravention of representations made that the pass-through Certificates involved valid, bona fide loans, the Certificates in fact were constituted by

loans that were known by Defendants to be worth a fraction of their represented value. The mortgages pooled were, viewed most charitably, high risk investments in properties of questionable value. The loans were not made to a diverse group of property owners, as represented, but instead were made to a small group of promoters such as West-Pac. The stated values of the properties had been grossly inflated by false and fraudulent appraisals. Consequently, the loans were not supported by sufficient collateral. Similarly, the mortgage insurance and performance bonds had been issued by carriers, Glacier General Assurance Company and Pacific American Assurance Company, known by Defendants to lack sufficient financial resources to meet their obligations; moreover, adequate reinsurance of these obligations had not been obtained. In short, the NMEC transactions were a sham and a fraud designed to enrich the Defendants at the expense of the Investor Institutions and the Bank.

More specifically, Defendants misrepresented and concealed the following:

(a) The loans placed in the pools did not conform to credit, appraisal, financial and underwriting standards set forth in the Placement Memorandum and the Servicing Agreement issued in connection with the sale by NMEC of the pass-through Certificates;

(b) The value of collateral underlyiung the notes and deeds of trust securing the Certificates was fraudulently misrepresented;

(c) The NMEC-approved mortgage guarantee insurance policies and financial performance bonds, purportedly providing for 100% coverage against default in payment of the trust deed notes, were fraudulent; and

(d) The pool funds were not used to acquire loans entered into by bona finde purchasers of residential real property, but were diverted to the personal use and benefit of NMEC, Feldman, West-Pac, Rogers, and other co-conspirators.

VIII. WRONGFUL ACTS AND OMISSIONS BY NMEC AND FELDMAN

NMEC and Feldman misrepresented the true nature of the loans they assembled for the NMEC pools as follows:

(a) Loans regularly exceeded the maximum amount of $500,000. In some cases this was accomplished by stacking multiple loans on a single piece of property;

(b) Loan-to-value ratios regularly exceeded 80%;

(c) Large numbers of loans involved residential dwellings composed of more than four units;

(d) Loans were made to borrowers without verification of creditworthiness; in many cases, the borrowers lacked assets

sufficient to support the level of indebtedness assumed.

NMEC and Feldman misrepresented the true value of the collateral properties. In fact, the true values of most loan properties could not support the level of borrowing funded. Large numbers of loans were not accompanied by a written appraisal based on the appraiser's personal inspection of the property. When appraisals were provided, most were fraudulently inflated far beyond true market value.

NMEC and Feldman misrepresented the true nature of the insurance secured for the NMEC loans as follows:

(e) In many cases, loans were not subject to private mortgage insurance or financial guarantee bonds of any kind.

(f) When insurance was provided, the promised coverage exceeded the financial capacity of the carriers. Neither Glacier General nor Pacific American had reinsured portions of their policies with other companies, foreign or domestic. Finally, Glacier General was not itself legally qualified to write insurance in California, where many of the properties were located.

(g) The insurance companies were selected not because they were able to provide adequate coverage but because they were related to participants in the fraudulent scheme. Pacific American was controlled by Defendants Rogers and West-Pac; the Bank is informed

and believes that principals of Glacier General likewise were involved through related entities in the diversion and misappropriation of funds.

(h) The insurance carriers themselves participated in the fraudulent scheme. After borrowers defaulted on loans subject to their insurance, the carriers recycled the collateral properties into the NMEC pools by selling them to related entities at inflated values; those entities made and marketed fictitious "loans" back to NMEC for inclusion in the pools.

NMEC and Feldman misrepresented the relationships among the entities involved in the NMEC transactions. The borrowers and lenders in many NMEC transactions were related entities acting to enrich themselves through self-dealing and secret profits. NMEC and Feldman did not disclose these facts and they continued to represent that the loans were conventional commercial transactions.

NMEC and Feldman failed to disclose information known to them about the principals involved in the NMEC transactions, namely:

(i) that Feldman was indicted in November 1981 and convicted in February 1982 of mail fraud and wire fraud; and

(j) that Rogers was indicted in September 1981 and convicted in February 1982 of conspiracy and fraud.

IX. WRONGFUL ACTS AND OMISSIONS BY LORD BISSELL AND MICHAEL

Lord Bissell and Michael failed to disclose in the Placement Memorandum the relationships among the entities involved in the NMEC transactions. Lord Bissell and Michael knew or should have known that the borrowers, lenders and insurers involved in many of the NMEC transactions were related entities acting to enrich themselves through self-dealing and secret profits. They also failed to disclose the convictions of Feldman and Johnson which was material to an investor's decision to entrust funds to NMEC and to the Bank's decision to serve as escrow agent and trustee.

NMEC, Feldman, Lord Bissell, and Michael continued to offer the Placement Memorandum to each new prospective Investor Institution without correcting these misstatements and omissions. Specifically, as the successive loan transactions ocurred, Lord Bissell and Michael knew, or were obligated to determine and with due diligence could have determined, that the pool loans, the collateral properties, the mortgage insurance, and the types of entities involved in the NMEC transactions did not conform to the representations made in earlier Placement Memoranda. Notwithstanding this information they knew or should have known, Lord Bissell and Michael failed to disclose that the true facts were not as they had represented. In addition, Lord Bissell and Michael knew or should have known of the accelerating default rate on the loans placed into the mortgage pools, but they failed to disclose this information in subsequent Placement Memoranda or otherwise.

Lord Bissell had specific knowledge of the deficiencies in the NMEC originated pools before Bank of America first acted as trustee in January 1983. Specifically, on or about December 17, 1982, Advance Mortgage Corporation, which had been the Servicer for four pass-through pools in which Wells Fargo Bank acted as trustee, wrote to Wells Fargo Bank and outlined the deficiencies in the NMEC loan pools. Advance Mortgage announced that it had decided to resign as Servicer after an investigation of the practices NMEC employed in the origination of mortgage loans. Advance Mortgage, a respected financial servicer, stated its "considered opinion that these practices have resulted in an inordinate number of first or second payment defaults, as well as unacceptable overall delinquency and foreclosure rates." Advance Mortgage stated that it had "ample reason to question the integrity of a number of the mortgage loans" and "grave doubts about the soundness of the pools." Advance Mortgage stated that appraisals it had conducted independently demonstrated property values from 25 to 50% less than those stated in the original appraisals. Advance Mortgage concluded that a substantial number of the loans were undersecured. Finally, Advance Mortgage pointed to the repetitive nature of the borrowers in the pools and the concentrated number of loans in a few hands. In short, Advance Mortgage had provided a virtual treasure map to the NMEC fraud. The Advance Mortgage letter was copied to Lord Bissell. Despite the disclosures contained in the Advance Mortgage letter, Lord Bissell and Michael continued to prepare and distribute private placement memoranda that failed to disclose any of the deficiencies and irregularities identified by Advance Mortgage.

Lord Bissell disclosed in subsequently prepared private placement memoranda that Advance Mortgage had resigned as Servicer, but intentionally failed to disclose the reasons for Advance Mortgage's resignation.

X. WRONGFUL ACTS AND OMISSIONS BY WEST-PAC AND ROGERS

West-Pac and Rogers knowingly and actively participated with NMEC and Feldman in the illicit scheme to conceal material information and to obtain secret profits through self-dealing with related entities and the creation of fictitious and fraudulently documented loans.

The scheme operated as follows: An entity related to or controlled by West-Pac or Rogers purchased property from a third party. The related entity and West-Pac then obtained a falsely inflated appraisal of the property. A "loan" was then documented by which it was made to appear that the related entity had sold the property to West-Pac and that West-Pac had, in exchange, executed a promissory note and trust deed in favor of the related entity. The fictitious loan was transferred to NMEC for inclusion in a mortgage pool.

West-Pac posed as a bona fide borrower when in fact it had no intention of honoring its promissory notes. In executing trust deeds as security for its loans, West-Pac misrepresented and

overstated the actual value of the collateral it supplied. West-Pac knew that the "sale" price was fictitious and not arrived at through an arm's-length transaction. West-Pac and Rogers arranged for and submitted fraudulently inflated appraisals. Once West-Pac and Rogers received NMEC investor funds for loans based on the inflated appraisals, they diverted the proceeds for their own purposes.

Pacific American, controlled by Rogers, executed mortgage insurance or financial guarantee bonds covering properties owned by West-Pac. West-Pac and Rogers represented in arranging to provide such coverage that Pacific American was qualified to act as insurer, when they knew that in fact Pacific American lacked the financial ability to support the level of insurance provided. West-Pac and Rogers also represented that Pacific American was providing coverage in a normal commercial capacity as a bona fide carrier, when in fact they knew, by virtue of Rogers' control of West-Pac and related entities, that Pacific American was an interested party in the transactions. West-Pac and Rogers further represented that Pacific American would secure reinsurance for the properties, when in fact it never did and West-Pac and Rogers never intended it to do so.

XI. CIRCUMSTANCES OF LOSS DECLARED BY BANK OF AMERICA

In or about October 1984, the Seamen's Bank For Savings, one of the Investor Institutions, advised Bank of America of certain irregularities in the processing and documentation of transactions

related to its purchase of pass-through certificates from NMEC. As a result of Seamen's inquiries, the Bank initiated an investigation that included a review of the performance by Bank employees of the escrow and trustee services provided in connection with the NMEC transactions. The Bank determined that certain employees had not adequately discharged the Bank's responsibilities as escrow agent and trustee. The Bank has initiated litigation, presently pending in the Los Angeles Superior Court, asserting state law claims against certain of its employees based upon their acts and omissions in connection with the NMEC transactions.

The Bank's investigation also revealed that the Investor Institutions, along with the Bank itself, had been victimized by the massive fraud devised and implemented by the Defendants as described in this document. The Bank recognized that the Investor Institutions would lose all or a significant portion of their investments in the NMEC pools. In response to the Investor Institutions' demands, the Bank undertook to resolve its obligations to them by repurchasing the Certificates or replacing the mortgages represented by the Certificates. In return, the Investor Institutions assigned to the Bank all interest they had in any properties or mortgage insurance securing the NMEC-originated loans. The Investor Institutions also assigned to the Bank all rights, claims, and causes of action they might have against parties responsible for their loss.

The total amount paid by the Bank in cash or replacement collateral to resolve its liability to the Investor Institutions was approximately $133 million. The Bank's present estimate of the realizable value of collateral and mortgage guarantee insurance claims assigned to it is $38 million. Accordingly, the Bank's present estimate of net loss in resolving its liability to the Investor Institutions is $95 million.

ADDENDUM TO BANK OF AMERICA'S PREVIOUS SUMMARY
PERTAINING TO NATIONAL MORTGAGE EQUITY CORPORATION

This Addendum supplements the Summary previously submitted by Bank of America pertaining to the National Mortgage Equity Corporation ("NMEC") mortgage pool scheme. This Addendum describes the escrow and trust services provided by the Bank, and describes the actions of certain bank employees in connection with those services.

Bank Escrow Services

In or about 1981, a bank employee agreed on behalf of Bank of America that the Bank would provide escrow functions in connection with NMEC's pooling of mortgages, receipt of funds from Investor Institutions, and disbursement of funds.1/

Pursuant to the escrow instructions, the bank employee in charge of these escrows ("escrow officer") had the following responsibilities:

(a) To receive funds from the investors and to invest those funds in instruments yielding the highest possible interest rate consistent with the expected close of escrow;

1/ In the two years that the Bank acted as escrow agent, Investor Institutions advanced funds exceeding $133 million to Bank of America for their purchase of mortgage-backed securities.

(b) To receive required mortgage loan documentation from NMEC and to hold those documents for the benefit of the investors;

(c) To make disbursements to title companies upon receipt of mortgage loan documentation;

(d) To furnish reports and information to the investors relating to the mortgage loan documentation received, held, or released by the Bank under the provisions of the escrow instructions;

(e) To promptly deliver to the investors, upon the investors' request, all mortgage loan documentation held by the Bank under the provisions of the escrow agreement;

(f) To distribute, on a loan-by-loan basis, the funds received from the investors upon deposit into escrow by NMEC of loan documentation providing the investors proper notes and deeds of trust that met the criteria set forth in the commitment letter between NMEC and the investor; and

(g) To deliver all mortgage loan documentation to the Trust Department of Bank of America in Los Angeles.

In or about October 1984, The Seamen's Bank For Savings, one of the Investor Institutions, advised Bank of America of certain irregularities in the processing and documentation of transactions underlying its purchase of mortgage-backed

certificates from NMEC. As a result of Seamen's inquiries, the Bank initiated an investigation which included a review of the performance by Bank employees of the escrow and trustee services provided in connection with the NMEC transactions. The Bank determined that bank employees had not adequately discharged the Bank's responsibilities as escrow agent and trustee, and had ignored or violated rudimentary banking practices and policies.

The escrow instructions relating to the mortgage pools had been violated and ignored in the course of processing the NMEC transactions. Escrow funds received from Investor Institutions had been disbursed to NMEC and NMEC-related entities before necessary documentation had been received. Funds from one loan pool had been transferred to cover shortfalls in other pools. Funds in loan pools had not been matched against particular loans, so it was not always possible to determine which loans had been purchased by which Investor Institutions. Required documentation was missing from a number of escrows.

The bank employee in charge of the escrows failed repeatedly to follow written escrow instructions and Bank policy. In some instances, the employee acted upon the oral instructions of NMEC representatives in contravention of the escrow instructions and Bank policy. Specifically, the escrow officer transferred funds from one escrow to another and misapplied investor funds. If an investor cancelled, rather than refund to that investor the monies it had placed in escrow, the escrow

offficer would repay the investor from another investor's escrow. In addition, the escrow officer routinely disbursed escrow proceeds without insuring that the Bank had received all of the documents required by the written escrow instructions or that disbursements were matched to individual loans.

The escrow officer also failed to reject escrow business which improperly required the escrow officer to make discretionary judgments in connection with the investment of funds, the propriety of deeds of trust, the adequacy of documentation, the form of mortgage guaranty insurance, the nature of the property made subject to the escrow, and the relationship of the loan to the appraised value of the real property.

The escrow officer also failed to maintain adequate records for each escrow to show receipt and disbursement of monies. She failed to insist on delivery of assignments of deeds of trust properly executed by NMEC. She disbursed funds after the stated termination date of the escrows. She failed to determine that the properties in the escrows comported with the pool requirements respecting nature of collateral, amount of loan, and loan to value ratios.

Bank Trust Services

On or about January 1983, bank employees agreed on behalf of Bank of America to furnish trustee services in connection with NMEC's marketing and issuance of certificates. Certificates were issued pursuant to a Pooling and Servicing Agreement ("the Agreement") between NMEC in its capacity as organizer and servicer of the mortgage pools and Bank of America as trustee.

Certain bank employees were assigned responsibility for the administration of the Bank's obligations as trustee under the Agreement. Pursuant to the Agreement, these duties included the following:

(a) To receive from NMEC and to review within 45 days all loan origination documents, including the mortgage note, the mortgage, an assignment, a title insurance policy, a certificate of insurance, and all other resolutions, certificates, statements, opinions, reports, documents, orders or other instruments furnished to the trustee as required by the Pooling and Servicing Agreement to determine whether those documents had been properly executed and conformed to the requirements of the Agreement;

(b) To notify NMEC promptly in writing of any defect or deficiency discovered in the course of the foregoing review, or of any breach by NMEC of its representations or warranties that materially and adversely affected the interests of the investors;

(c) To accept assignment, transfer, and conveyance by NMEC without recourse to the trustee of all right, title, and interest of NMEC in and to the mortgage loans included in each of the mortgage pools;

(d) To certify the authenticity of the mortgage-backed securities issued by NMEC; and

(e) To exercise all rights and powers vested in it as trustee by the Agreement in the event of default.

Trust duties had not been properly performed by bank employees ("trust officers"). Under the Pooling and Servicing Agreement, the Trust Department was required to ensure that all necessary documents had been received from NMEC and that the loans and supporting documentation conformed to the requirements of the Pooling and Servicing Agreement. The Bank's trust officers failed to perform this responsibility, as demonstrated by the fact that missing and nonconforming documents tainted virtually each loan pool.

Specifically, these deficiencies in trust and/or escrow documentation included, but were not limited to, the following:

(a) written appraisals of property serving as collateral for the loans were missing;

(b) multiple loans had been issued against the same property;

(c) loans had been issued for more than 80% of the value of the property;

(d) loans had been issued in excess of the $500,000 limit;

(e) loans had been issued that lacked valid mortgage insurance or financial performance bonds;

(f) loans had been issued on property that was not eligible for inclusion in the pools; and

(g) monthly remittance reports identifying funds remitted to certificate holders were not received.

More particularly, trust officers executed trustee's receipts for mortgage loans, representing that the Trust Department had received the mortgage files, when the Trust Department had not yet received or reviewed those documents. Trust officers permitted, and in some instances signed for, the authentication of Certificates before the Bank had received the

required documentation from NMEC or before the Trust Department had received the required documentation from the Bank's escrow officers. Trust officers failed to comply with the requirements imposed upon the trustee by the Pooling and Servicing Agreement. These included the trustee's obligations (i) to review loan origination documents within 45 days to ensure that all documents were properly executed and conformed to the requirements of the Agreement; and (ii) to provide written notice to NMEC of any defective documentation or noncompliance discovered in that review or of NMEC's breach of its representations and warranties to the Bank as trustee.

Each of the defective mortgage pools sustained a major loss in value. Many of the mortgages that comprised the pools were in default. The defaulting borrowers on large numbers of loans were related to other entities involved in the NMEC transactions. Collateral was inadequate to cover the losses for numerous reasons: values of the properties had been fraudulently inflated; loans had exceeded the maximum loan to value ratio; and in some cases multiple loans had been secured by a single property. Mortgage guarantee insurance either was issued by companies without the financial resources to pay the claims or, in some instances, was missing from the loan package.

The Bank recognized that the Investor Institutions would lose all or a significant portion of their investments in the NMEC pools. The Bank also recognized that the conduct of its employees most likely rendered it liable to the Investor Institutions for any loss they might suffer. In response to the demands of the Investor Institutions, the Bank undertook to resolve its obligations to them by repurchasing the Certificates or replacing the mortgages represented by the Certificates. In return, the Investor Institutions assigned to the Bank all interest they had in any properties or mortgage insurance or financial guarantee bonds securing the NMEC originated loans. The Investor Institutions also assigned to the Bank all rights, claims, and causes of action they might have against Bank officers, employees, agents or other third parties responsible for their loss. The assignments of claims by the Investor Institutions are embodied in Settlement Agreements entered into between the Bank and the Investor Institutions.

The total amount paid by the Bank in cash or replacement collateral to resolve the Investor Institutions claims was approximately $133 million. The Bank's present estimate of the realizable value of collateral and mortgage guarantee insurance claims assigned to it is $38 million. Accordingly, the Bank's present estimate of net loss in resolving the Investor Institutions claims is $95 million.

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